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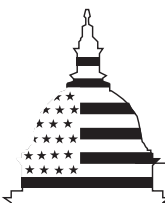
Report to the Chairman, Subcommittee on  
Space and Aeronautics, Committee on  
Science, House of Representatives

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March 2001

# FINANCIAL MANAGEMENT

## Misstatement of NASA's Statement of Budgetary Resources



G A O

Accountability \* Integrity \* Reliability

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| <b>Abstract</b><br>In June 2000, the House Committee on Science identified a significant discrepancy between an amount reported in the National Aeronautics and Space Administrations (NASA) audited financial statements for fiscal year 1999 and its submission in the Presidents Budget for fiscal year 2001. The Committees inquiry into this discrepancy resulted in NASAs Chief Financial Officer (CFO) subsequently determining that the information in the audited financial statements was in error by about \$644 million. The error occurred in NASAs Statement of Budgetary Resources (SBR), a financial statement that was required for federal agencies beginning in fiscal year 1998. The NASA Office of the Inspector General (IG), which is responsible for conducting or arranging for an independent audit of NASAs financial statements, contracted with Arthur Andersen LLP to meet this requirement. |                           |   |
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United States General Accounting Office  
Washington, DC 20548

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March 30, 2001

The Honorable Dana Rohrabacher  
Chairman, Subcommittee on Space and Aeronautics  
Committee on Science  
House of Representatives

Dear Mr. Chairman:

In June 2000, the House Committee on Science identified a significant discrepancy between an amount reported in the National Aeronautics and Space Administration's (NASA) audited financial statements for fiscal year 1999 and its submission in the President's Budget for fiscal year 2001. The Committee's inquiry into this discrepancy resulted in NASA's Chief Financial Officer (CFO) subsequently determining that the information in the audited financial statements was in error by about \$644 million. The error occurred in NASA's Statement of Budgetary Resources (SBR), a financial statement that was required for federal agencies beginning in fiscal year 1998. The NASA Office of the Inspector General (IG), which is responsible for conducting or arranging for an independent audit of NASA's financial statements, contracted with Arthur Andersen LLP to meet this requirement.

The SBR is intended to provide information on an agency's use of budgetary resources provided by the Congress. If reliable, the SBR can provide valuable information for management and oversight purposes to assess the obligations related to prior-year agency activities and to make decisions about future funding. Certain information presented in the SBR is also presented in the Statement of Financing, another relatively new federal financial statement also first required in fiscal year 1998. This statement is intended to explain how budgetary resources obligated during the period relate to the net cost of operations for that reporting entity. We have previously reported that several agencies were not properly reconciling and disclosing differences between amounts in their SBRs and

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the President's Budget, and improvements could be made by auditors to adequately document the results of SBR audit procedures performed.<sup>1</sup>

This report is in response to your request that we review (1) the nature and causes of the discrepancy between NASA's SBR and its budget documents, and also the adequacy of Office of Management and Budget (OMB) and related guidance available on the preparation of the SBR, (2) the adequacy of the auditing procedures performed by Arthur Andersen on the SBR and the Statement of Financing in NASA's fiscal year 1999 accountability report, and (3) the role of the NASA IG in overseeing Arthur Andersen's audit.

To fulfill these objectives, we reviewed documentation of the NASA CFO's preparation of the budgetary statements for fiscal year 1999, Arthur Andersen's working papers supporting its audit of the budgetary statements, and the documentation prepared by the NASA IG related to its oversight of the audit. In addition, we spoke to NASA CFO, Arthur Andersen, and NASA IG officials about the preparation and audit of the budgetary statements. We reviewed applicable Treasury, OMB, and NASA guidance as well as related generally accepted accounting principles and concepts that relate to budgetary accounting. We also reviewed applicable OMB, GAO, and American Institute of Certified Public Accountants (AICPA) standards related to federal financial statement audits. Because we did not audit NASA's financial statements, we do not express an opinion on the statements for fiscal years 1999 or 1998, as originally presented, or as restated in NASA's revised Statement of Budgetary Resources for fiscal years 1999, 1998, and 1997. Further, consistent with our objectives, our review focused only on the audit of the budgetary statements and, thus, we cannot conclude on the adequacy of Arthur Andersen's work on the other principal statements, its report on internal control and compliance with laws and regulations, or whether NASA's systems comply substantially with the Federal Financial Management Improvement Act (FFMIA).<sup>2</sup> Our work was performed from October 2000 to February 2001 in accordance with generally accepted government

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<sup>1</sup> *Federal Accounting and Reporting: Framework for Assessing the Reliability of Budget Execution Data Is Not Yet Fully Implemented* (GAO-01-43, October 6, 2000).

<sup>2</sup> FFMIA requires that agencies implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Government Standard General Ledger (SGL) at the transaction level.

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auditing standards. Further details on our scope and methodology are in appendix I.

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## Results in Brief

NASA's fiscal year 1999 SBR was misstated by a reported \$644 million due, in part, to a misinterpretation of guidance and errors in NASA's ad hoc process for generating budgetary information. The misstatement was in the "Recoveries of Prior Year Obligations" line of the statement. The overstatement of this line item indicated to users of NASA's budgetary reports that additional funds, which did not in fact exist, were available for new obligations or to cover increases in existing obligations and could have been used to reduce needed funding. NASA has subsequently reported that its reporting of no "Recoveries" for fiscal year 1998 was also in error. The bulk of the fiscal year 1999 error was caused when NASA headquarters officials erroneously added a category of transactions—disbursements from expired appropriation accounts—to the "Recoveries" line.

NASA headquarters officials have stated that they mistakenly included these transactions because they misinterpreted the applicable OMB guidance on this line of the SBR. OMB guidance calls for using the Recoveries line to report downward adjustments of obligations incurred in prior fiscal years that were not outlayed. The guidance contained in OMB Circular A-34 and the Treasury *Financial Manual* provides detailed instructions on the form and content of the various line items comprising the SBR, including the Recoveries line.

NASA used an ad hoc process to gather the required information for certain line items on the SBR because NASA's reporting units (NASA headquarters and nine centers) do not have the corresponding general ledger accounts to capture the adjustments specified in the OMB guidance. As a result, the NASA locations used various methods to extract the data for this line item from their separate systems and entered the data on spreadsheets, which were then compiled by NASA headquarters. NASA officials have indicated that undetected errors in this spreadsheet process—in addition to the inclusion of the erroneous category of transactions—were also responsible for a portion of the SBR misstatement. According to NASA officials, they have strengthened internal controls over this process for fiscal year 2000.

Arthur Andersen did not detect the error in NASA's SBR during its audit of the fiscal year 1999 financial statements. Evidence in Arthur Andersen's

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working papers relating to understanding and testing internal controls and validating underlying data for key financial statement balances was not adequate to support Arthur Andersen's unqualified audit opinion<sup>3</sup> on the SBR and Statement of Financing for fiscal year 1999. Generally accepted government auditing standards (GAGAS) require an auditor to gain a sufficient understanding of internal controls to plan the audit and to obtain sufficient competent evidential matter to render an opinion on the financial statements. Although Arthur Andersen's working papers contained NASA-prepared flowcharts relating to the budget formulation and execution processes at one of NASA's centers, these flowcharts did not identify the related internal controls. Also, for fiscal year 1999, Arthur Andersen performed limited testing of internal controls related to the SBR and Statement of Financing. Arthur Andersen's audit management team told us that they did not become aware of NASA's ad hoc procedures used for the Recoveries line item until after the Committee discovered the discrepancy in June 2000.

We found that Arthur Andersen's audit of the SBR and the Statement of Financing was characterized by excessive reliance on representations by NASA management, which led to an inappropriate assessment of risk related to the budgetary statements and resulted in the absence of any independent validation of underlying data for key balances. For the Recoveries line item on the SBR, the work performed was evidenced by one paragraph in the auditor's working papers documenting statements by management of why the balance had increased from \$0 for fiscal year 1998 to \$686 million for fiscal year 1999. We did not see any documentation in Arthur Andersen's working papers to show independent verification of the reasonableness of the balance despite an explanation from management that raises questions about the fiscal year 1998 as well as the fiscal year 1999 Recoveries balance. We also did not find documentation of any validation of underlying data for other key balances in the budgetary statements such as "Undelivered Orders," which had a \$2.2 billion balance at September 30, 1999. Financial statement audits of other federal agencies have identified high error rates when testing underlying data for accounts such as Recoveries and Undelivered Orders.

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<sup>3</sup>An unqualified, or clean, audit opinion means that the auditor believes that information presented in the financial statements as a whole is presented fairly, in all material respects, in accordance with generally accepted accounting principles.



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The systems deficiencies that led to the SBR error and Arthur Andersen's lack of understanding of the ad hoc process used by NASA to work around these deficiencies also raise questions about Arthur Andersen's conclusion that NASA's financial management systems comply substantially with FFMIA. The act requires agencies to implement and maintain financial management systems<sup>4</sup> that comply substantially with federal financial management systems requirements, applicable generally accepted accounting principles, and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. The need for the ad hoc process and the resulting error raise questions related to all three FFMIA requirements. For example, substantial manual efforts were required at year-end because NASA did not have general ledger accounts to accumulate transactions related to Recoveries during fiscal year 1999. In addition, because of the \$644 million error, the presentation of the Recoveries line did not comply with generally accepted accounting principles. The primary evidence relied upon by Arthur Andersen to support its conclusions on FFMIA compliance was a memorandum from NASA management explaining why it believed NASA's systems comply with FFMIA.

The NASA IG letter transmitting Arthur Andersen's report to the NASA Administrator and Chief Financial Officer included in the *Fiscal Year 1999 Accountability Report* stated that the IG did not express opinions on NASA's financial statements or on conclusions about the effectiveness of internal controls and compliance with laws and regulations. The letter stated that Arthur Andersen was responsible for the auditor's report and for the conclusions expressed in the report. The NASA IG reviewed Arthur Andersen's working papers and audit reports using a detailed checklist it developed based on GAGAS. The NASA IG did not identify the error in the SBR or question the extent of the audit procedures Arthur Andersen applied to the budgetary statements or to assess compliance with FFMIA. To improve the quality and consistency of future audits, beginning with fiscal year 2001, the NASA IG will require its independent public accountant to perform the audits in accordance with the *GAO/President's Council on Integrity and Efficiency Financial Audit Manual*.

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<sup>4</sup>OMB Circular A-127, revised July 23, 1993, *Financial Management Systems*, defines financial management systems as a unified set of financial systems that are planned for and managed together, operated in an integrated fashion, and linked together electronically in an efficient and effective manner to provide agencywide financial system support necessary to carry out an agency's mission and support its financial management needs.

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We are making recommendations that address the need for (1) the NASA CFO to ensure that the policies and procedures used to prepare the SBR are effective and (2) the NASA IG to review the procedures it uses to oversee the work of its independent public accountants. In commenting on a draft of this report, NASA management concurred with our recommendation regarding improvements in the financial statement preparation process, and the NASA IG concurred with our recommendation on the audit quality control review process. In addition, NASA management concurred with our conclusion regarding the misstatement in the fiscal year 1999 SBR.

However, Arthur Andersen and the NASA IG disagreed with our analysis in most areas. Arthur Andersen stated that it believes that our conclusion concerning the adequacy of its work on the 1999 NASA audit is fundamentally incorrect. The NASA IG also disagreed with our conclusion on the adequacy of Arthur Andersen's audit work on the 1999 SBR and Statement of Financing. We disagree with the Arthur Andersen and NASA IG comments. The evidence in Arthur Andersen's working papers—including the 1996, 1997, and 1998 working papers we were provided—was not adequate to support unqualified audit opinions on the fiscal year 1999 SBR and Statement of Financing.

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## Background

NASA is required to prepare annual financial statements and have them audited under the mandate of the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994 (GMRA). OMB's implementing guidance<sup>5</sup> indicates that the principal financial statements are the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, and the Statement of Financing. GMRA requires that agencies submit audited financial statements to OMB no later than March 1 for the preceding fiscal year. These statements are to be prepared in accordance with generally accepted accounting principles (GAAP).<sup>6</sup> In addition, FFMIA requires that agencies implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable generally accepted

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<sup>5</sup>OMB bulletin 97-01, *Form and Content of Agency Financial Statements*, as amended.

<sup>6</sup>The Federal Accounting Standards Advisory Board (FASAB) promulgates GAAP for federal government entities.

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accounting principles, and the SGL at the transaction level. Audits of an agency's financial statements are intended, in part, to provide for the production of complete, reliable, timely, and consistent financial information for use by management and the Congress in the financing, management, and evaluation of federal programs. As part of the annual financial statement audit, FFMA requires the auditor to report whether the agency's financial management systems comply substantially with its requirements.

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## Description of Budgetary Statements

The SBR was designed to provide information on budget execution amounts, including budgetary resources, availability of budgetary resources, and how obligated resources have been used.<sup>7</sup> The SBR consists of three separate but related sections that provide information about budgetary resources, status of budgetary resources, and outlays<sup>8</sup> for major budgetary accounts.

- **Budgetary Resources.** This section shows total budgetary resources made available to the agency for obligation<sup>9</sup> during the reporting period. It consists of new budget authority, unobligated amounts available from prior reporting periods, transfers available from prior-year balances, reimbursements and other income, and adjustments such as recoveries of prior-year obligations.
- **Status of Budgetary Resources.** This section displays the status of budgetary resources at the end of the period and consists of obligations incurred and the unobligated balances at the end of the period that are either available or are unavailable except to adjust or liquidate obligations chargeable to prior period appropriations. The

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<sup>7</sup>OMB issues form and content guidance for federal agency financial statements including the SBR. The SBR follows the structure outlined in the Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, *Entity and Display*, using the definitions from the Statement of Federal Financial Accounting Standards (SFFAS) No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.

<sup>8</sup>Outlays are the measure of government spending. They are payments to liquidate obligations, other than the repayment of debt. Outlays generally are equal to cash disbursements but also are recorded for cash-equivalent transactions, such as the subsidy cost of direct loans and loan guaranties and interest accrued on public issues of public debt.

<sup>9</sup>An obligation is a binding agreement that will result in outlays, immediately or in the future. Budgetary resources must be available before obligations can be incurred legally.

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total for this section and for the Budgetary Resources section must agree.

- **Outlays.** This section shows the relationship between obligations and outlays and discloses the payments made to liquidate obligations, net of offsetting collections.<sup>10</sup> Obligations are usually liquidated by means of cash payments (outlays) such as currency, checks, or electronic fund transfers. This section reconciles outlays with obligations incurred and the change in obligated balances during the year.

Recoveries of Prior Year Obligations, the specific line in which the NASA misstatement occurred, is reported in the budgetary resources section of the SBR. Typically, recoveries of prior-year obligations are included in the Adjustments line item on the SBR. Recoveries of Prior Year Obligations, as defined in OMB Circular A-34, *Instructions on Budget Execution*, are cancellations or downward adjustments of obligations incurred in prior fiscal years that were not outlayed. For example, if an undelivered order established in a prior year for \$1,000 relates to a contract that has been canceled, then a downward adjustment of \$1,000 for obligations would be recorded. Certain recoveries of prior-year obligations result in budgetary resources that are available for new obligations while others are available only for upward adjustments of valid prior-year obligations.

The SBR provides the means to assess the reliability of certain budget execution data presented in the President's Budget by linking audited data from the SBR to the "actual" column on the agency's Program and Financing (P&F) Schedules included in the Budget. OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*, requires agencies to disclose any material differences between amounts in the SBR and amounts reported as actuals in the P&F Schedule. Further, the guidance requires agencies to report budgetary information in the SBR based on budget terminology, definitions, and guidance issued in OMB Circular A-34. In addition, the Department of the Treasury's *Financial Manual* contains an SGL Supplement that is released annually that reports crosswalks of SGL accounts that feed into specific line items for the principal financial statements, including the SBR. OMB Circular A-34, in turn, provides guidance on the preparation of the agency's Report on

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<sup>10</sup> Offsetting collections result from business-type transactions with the public and other government accounts. They are deducted from gross budget authority and outlays, rather than added to receipts, and by law are credited directly to expenditure accounts.

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Budget Execution and Budgetary Resources (Standard Form 133), which can be used as the source of information for the SBR.

The Statement of Financing explains how budgetary resources obligated during the period relate to the net cost of operations.<sup>11</sup> This information should be presented in a way that clarifies the relationship between the obligation basis of budgetary accounting and the accrual basis<sup>12</sup> of proprietary accounting.<sup>13</sup> By explaining this relationship through a reconciliation process, the statement provides information necessary to understand how budgetary (and some nonbudgetary) resources finance the cost of operations and affect the assets and liabilities of the reporting entity. Two line items on the Statement of Financing are also reported on the SBR: “obligations incurred” and “spending authority from offsetting collections and adjustments.” The amounts reported for these items should be the same on both statements.

The SBR and the Statement of Financing are relatively new financial statements that are unique to the federal government. The auditor’s understanding of these statements and the internal controls underlying their preparation are, therefore, especially important to rendering an opinion on whether the financial statements are fairly stated.

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## Financial Statement Audit Requirements

Federal financial statements are to be audited in accordance with GAGAS.<sup>14</sup> For financial statement audits, GAGAS incorporates the

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<sup>11</sup> An agency’s net cost of operations is the gross cost incurred, less any exchange revenue (e.g., user fees) earned from its activities.

<sup>12</sup> The accrual basis of accounting refers to the practice of recognizing revenues when earned and expenses when incurred, without regard to the time of receipt or payment of cash. The accrual basis of accounting is contrasted with the cash basis, under which revenue is recognized only when the cash is received, and expenses are recorded only when the cash is paid.

<sup>13</sup> The budgetary accounting system is used to keep track of spending authority at various stages of budget execution from appropriation, to apportionment of an allotment, to obligation, and eventual outlay. Proprietary accounts are used to record all nonbudgetary activity in the government, such as information about the operations of the government’s programs, assets, and liabilities.

<sup>14</sup> GAGAS, promulgated by the Comptroller General of the United States, are to be followed by federal auditors and audit organizations and by other auditors auditing federal organizations, programs, or activities when required by law, contract, or policy. These standards pertain to auditors’ professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

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standards of the AICPA. Financial statement audits of federal departments and agencies, performed in accordance with GAGAS, are intended to provide reasonable assurance about whether the financial statements for an audited entity present fairly, in all material respects, its financial position, net cost, changes in net position, budgetary status, and financing (e.g., reconciliation of net costs to budgetary obligations), in conformity with generally accepted accounting principles. GAGAS for financial audits prescribe additional standards in the following three areas.

- General standards contain requirements on auditor qualifications, independence, due professional care, and quality control.
- Fieldwork standards contain requirements on audit planning, irregularities, illegal acts and other noncompliance, internal controls, sufficient competent evidential matter, and working papers.
- Reporting standards contain requirements on elements of the auditors' reports.

The three generally accepted standards of fieldwork issued by the AICPA and incorporated into GAGAS are as follows.

- The work is to be adequately planned and assistants, if any, are to be properly supervised.
- A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statement under audit.

Audit standards for fieldwork generally encompass the planning and performance of the audit and the sufficiency and competency of evidential matter obtained to support an auditor's conclusions and opinions. Audit fieldwork standards also require that a sufficient understanding of an entity's internal control be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. Standards also require that auditors retain a written record of their audit evidence in the form of working papers. The information contained in working papers constitutes the principal record of the work that the auditor has performed and the conclusions that the auditor has reached. GAGAS have additional working paper standards that require that the working papers contain sufficient information to enable an experienced auditor having no previous

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connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

The AICPA has issued Statements on Auditing Standards (SAS) that interpret its standards of fieldwork and reporting. SAS are issued by the Auditing Standards Board, the senior technical body of the AICPA designated to issue pronouncements on auditing matters. OMB Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, establishes the minimum requirements for audits of federal financial statements. OMB audit guidance requires auditors (1) to report whether agencies' financial statements are fairly presented in all material respects, in conformity with GAAP, (2) to obtain an understanding of the components of internal controls and assess the level of control risk, and (3) to test whether agencies comply with laws and regulations that have a direct and material effect on the financial statements. In addition, as part of the financial statement audit, the auditor is to report whether an agency's financial management systems comply substantially with FFMIA. OMB requirements incorporate both GAGAS and AICPA audit standards.

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## Role of Agency Inspectors General

Inspectors General have the general responsibility under the Inspector General Act of 1978 to take steps to ensure that the work of nonfederal auditors complies with GAGAS. Further, under the CFO Act, NASA's Office of Inspector General is responsible for performing an audit or contracting with an independent external auditor to perform an audit of the agency's annual financial statements in accordance with GAGAS. OMB Bulletin No. 98-08 also requires that the Inspectors General (1) ensure that audits conducted by the IG staff and audits conducted by independent auditors under contract are performed and audit reports completed in a timely manner and in accordance with the requirements of OMB Bulletin No. 98-08, (2) provide technical advice and liaison to agency officials and independent external auditors, (3) obtain or conduct quality control reviews of audits made by independent external auditors, and (4) monitor and report on management's progress in resolving audit findings.

The NASA IG performed financial statement audits of NASA beginning with fiscal year 1992. For fiscal years 1992 and 1993, the NASA IG was unable to express an opinion on the financial statements. The NASA IG expressed an unqualified opinion on NASA financial statements for fiscal years 1994 and 1995, meaning that the auditor believed that the information presented in the financial statements as a whole was fairly presented, in all material respects, in accordance with generally accepted

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accounting principles in effect at the time. The NASA IG contracted with Arthur Andersen for NASA's financial statement audit beginning with fiscal year 1996. The 5-year fixed-fee contract covered the audits, which were to be conducted in accordance with GAGAS, for fiscal years 1996 through 2000. Arthur Andersen's audit fees were \$650,000 for each of the first 4 years, and \$680,000 for fiscal year 2000, comprising a total of approximately \$3.3 million. Arthur Andersen expressed unqualified opinions on the fiscal years 1996 through 1999 financial statements. Also, for fiscal years 1997 through 1999, Arthur Andersen reported that NASA's financial management systems were in substantial compliance with FFMIA.

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## Causes of NASA's SBR Misstatement

OMB Circular A-34 and the Treasury *Financial Manual* provide detailed instructions on the preparation of the various line items comprising the SBR, including a description of the specific SGL accounts to be included in the Recoveries line. However, NASA's general ledger system did not include the accounts needed to capture the data for the Recoveries line. As a result, NASA had to rely on an ad hoc process that included a data call from the reporting units' (nine centers and headquarters) separate systems and a compilation of reported amounts using a spreadsheet. In addition, when compiling these data, NASA headquarters mistakenly added amounts that were not relevant to the Recoveries line. Headquarters officials stated that the error resulted from their misinterpretation of the OMB guidance on what to include in the Recoveries line. NASA is currently acquiring and implementing a single, commercial-off-the-shelf core accounting system that it believes will ameliorate the system problems identified. As we have previously reported,<sup>15</sup> other agencies have had problems preparing the SBR. According to NASA, it has strengthened internal controls over this process for fiscal year 2000.

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## OMB and Treasury Guidance Provide Information on Form and Content of SBR Line Items

The guidance available to NASA and other federal agencies on the accumulation and presentation of budgetary execution information includes specific instructions on which SGL accounts flow to which line items on the SBR. OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*, provides the format and instructions for the overall layout of the various sections of the SBR. The bulletin refers the reader to

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<sup>15</sup> *Federal Accounting and Reporting: Framework for Assessing the Reliability of Budget Execution Data Is Not Yet Fully Implemented* (GAO-01-43, October 6, 2000).



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OMB Circular A-34, *Instructions on Budget Execution*, for more specific guidance on the contents of line items included in the SBR. The SBR includes, in condensed form, information that OMB Circular A-34 requires agencies to report on the SF 133. OMB Circular A-34 provides detailed instructions on the applicable definitions, concepts, and terminology, as well as specific line-by-line instructions, for reporting budgetary execution information. The circular also provides a crosswalk that links the SF 133 to other budgetary reports, including the President's Budget and the *Treasury Annual Report Appendix*.

The SGL provides a uniform Chart of Accounts and technical guidance to be used in standardizing federal agency accounts. Agency financial management systems' compliance with the SGL at the transaction level is one of the three requirements of FFMA. The Department of the Treasury's *Financial Manual* contains an annual SGL Supplement that includes the Chart of Accounts, account descriptions, accounting transactions, SGL attributes, and report crosswalks for the various principal financial statements. According to the *Financial Manual* crosswalk for fiscal year 1999, the "Recoveries of Prior Year Obligations" line on the SBR included the following SGL accounts:

- Account 4871, Downward Adjustments of Prior-Year Unpaid Unexpended Obligations<sup>16</sup>
- Account 4971, Downward Adjustments of Prior-Year Unpaid Expended Authority<sup>17</sup>

In addition, Treasury's Financial Management Service produces a *Budgetary Accounting Guide*, available on the Treasury web site, which provides guidance for the proper recording of budgetary accounting events and completing common budget reports.

The SBR is a relatively new financial statement and is unique to the federal government. As a result, many federal agencies face challenges in the preparation of reliable budget execution data reported in the SBR. For

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<sup>16</sup>Defined as the amount of downward adjustments during the fiscal year to unpaid unexpended obligations that were recorded in a prior year. Unpaid unexpended obligations reflect the amount of goods or services ordered and obligated but not yet received and not yet paid for (e.g., unpaid undelivered orders).

<sup>17</sup>Defined as the amount of downward adjustments during the fiscal year to unpaid expended authority that were recorded in a prior year. Unpaid expended authority reflects costs for goods and services received but not paid for (e.g., accounts payable).

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example, as part of the preparation of the SBR, agencies are required<sup>18</sup> to disclose any material differences between amounts in the SBR and amounts reported as actual in the President's Budget P&F Schedules. This disclosure helps to link budgetary amounts in the audited financial statements and information in the President's Budget. NASA did not disclose in a footnote to the financial statements the significant difference between the Recoveries as reported on the SBR and as reported on the P&F Schedules. As stated in our October 2000 report, some other agencies also did not disclose significant differences in those amounts.

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### Ad Hoc Process Used to Gather and Submit Data Not Captured by NASA's General Ledger Systems

To collect the data needed for the Recoveries line, personnel from NASA headquarters Accounting, Reporting and Analysis Branch (part of the Office of the Chief Financial Officer) instructed the nine centers and headquarters accounting division to provide data on Excel spreadsheets. The memorandum to the 10 reporting units provided minimal guidance on the types of downward adjustments to accumulate on the spreadsheets. Specifically, the memorandum included a request for data that would be reported in SGL accounts 4871 and 4971, in accordance with Treasury's *Financial Manual*.

Because the reporting units' automated systems did not contain general ledger accounts that would capture the type of data included in SGL accounts 4871 and 4971, the units used various procedures and system queries to extract the requested data. Because each of the reporting units maintain different accounting systems, it was left up to the units to determine how best to gather the requested data. For example, some reporting units wrote data extraction programs or queries to obtain the data from their accounting systems, one unit did not use its accounting system and instead requested the information from its Procurement Division, and at least one unit developed written formal instructions to gather the data. After preliminary data were obtained, the reporting units performed a manual review to determine which transactions met their criteria for a downward adjustment. We found that no one in the CFO's office validated the completeness or accuracy of underlying data that was submitted by the reporting units for inclusion in NASA's Fiscal Year 1999 *Accountability Report*. We noted that after the House Committee on Science identified the error in the SBR, NASA's Office of the CFO staff

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<sup>18</sup>This requirement is found in SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.

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sent a memorandum to the reporting units stating that an analysis of the data submitted revealed significant misinterpretations by the units of its guidance for identifying transactions that qualify as downward adjustments.

NASA CFO personnel received the spreadsheet data from each of the 10 reporting units and compiled a consolidated amount. In doing so, CFO personnel decided to add other data to the totals submitted by the reporting units. Specifically, CFO personnel mistakenly believed that disbursements from expired appropriation accounts<sup>19</sup> should be included in the Recoveries line item in the SBR, although this information is not relevant to this line. Using summary data reported by each of the reporting units in their general ledgers, CFO personnel calculated an amount that they believed represented disbursements from expired appropriation accounts for the year. NASA officials stated that they misinterpreted OMB guidance on what to include in the Recoveries line.

The House Science Committee discovered the discrepancy in comparing the SBR Recoveries line in the financial statements (\$686 million) to the related line in the President's Budget P&F Schedules (\$56 million). After the Committee discovered the discrepancy, NASA's CFO personnel determined that it had made an error and initially revised the SBR amount to \$94 million, a reduction of \$592 million from the amount originally reported on the SBR. NASA subsequently restated the fiscal year 1999 amount in response to the Committee's request, reducing the SBR amount by another \$52 million to \$42 million, which increased the amount of the error to \$644 million. Based on our discussions with NASA staff and a review of relevant documentation, all but about \$32 million of the error related to the inclusion of the calculated amount of disbursements from expired appropriations in the Recoveries line. The remaining amount was attributed to other errors found in the spreadsheet data submitted by the reporting units.

The error in the SBR was also in NASA's SF 133s prepared for fiscal year 1999. However, the portion of the misstatement in the budgetary information reported in the SBR and SF 133s related to expired

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<sup>19</sup> An appropriation account in which the balance is no longer available for incurring new obligations because the time available for incurring such obligations has expired. Expired accounts are maintained for 5 years. During this 5-year period, obligations may be adjusted if otherwise proper and outlays may be made from these accounts.

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appropriation accounts was not carried over into the President's Budget because the P&F Schedules do not report activity in expired accounts related to recoveries of prior-year obligations. The other errors of approximately \$32 million related to errors in the spreadsheet data may have had an impact on the P&F Schedules. However, because NASA did not prepare revised SF 133s to separate the amounts between current and expired appropriations, the actual dollar amount of the effect is not known.

In a written response to the Committee's request for a complete explanation of the error, NASA's Associate Administrator for Legislative Affairs stated, "The misinterpretation of available guidance and the resulting misclassification on the Statement of Budgetary Resources was not identified by NASA at the time of statement development because the statement preparers thought that all changes associated with expired appropriations should be reflected as adjustments in the Statement of Budgetary Resources.... The preparers subsequently realized that other guidance, including Office of Management and Budget (OMB) Circular A-34 and the Treasury Financial Manual, clarified the financial statement preparation guidance."

According to NASA officials, they have strengthened internal controls over the financial statement preparation process for fiscal year 2000. Specifically, in response to the Committee, as well as in our follow-up discussions, NASA officials stated that they have instituted additional independent verification and validation of data used in the financial statement reporting process to ensure accuracy and understanding and adherence to federal guidance. According to NASA's response to the Committee, this process will include a critique and verification of the contents of the statements by knowledgeable NASA professionals, in addition to the primary preparers and to the independent auditors.

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## Audit Evidence Inadequate for Budgetary Statements

Arthur Andersen did not detect the error in NASA's SBR during its audit of the fiscal year 1999 financial statements. Evidence in Arthur Andersen's working papers was not adequate to support unqualified audit opinions on NASA's SBR and Statement of Financing in accordance with GAGAS. Arthur Andersen's working papers did not adequately document the evaluation of the internal controls related to the two budgetary statements or the independent validation of key amounts in the statements for fiscal year 1999. In addition, the deficiencies in NASA's general ledger and the error in NASA's SBR described earlier raise questions about Arthur

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Andersen's conclusion that NASA's systems complied substantially with the requirements of FFMIA. We found inadequate evidence in Arthur Andersen's working papers to support its conclusion on NASA's FFMIA compliance. Finally, the revised SBR amounts submitted to the House Committee on Science were not subject to independent audit. However, NASA IG officials told us that they asked Arthur Andersen to verify the revised fiscal year 1999 SBR amounts as part of NASA's fiscal year 2000 audit, which was not complete at the time of our review.

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## Understanding of Internal Control

GAGAS and SAS No. 55 require consideration of internal control in a financial statement audit. Further, OMB Bulletin No. 98-08<sup>20</sup> requires that the federal financial auditor report weaknesses in an agency's internal controls. GAGAS require that the auditor obtain an understanding of internal controls sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and whether they have been placed in operation.

After obtaining this understanding, the auditor is to assess the risks embodied in the financial statements and may obtain evidential matter about the effectiveness of both the design and operation of controls that support a lower assessed level of risk. The auditor uses the knowledge provided by the understanding of internal controls and the assessed level of risk in determining the nature, timing, and extent of substantive tests to be performed. Substantive tests are intended to independently validate specific balances and can include analytical procedures<sup>21</sup> or detail tests such as

- confirmation of balances with third parties (e.g., banks),
- physical observation, such as inspection of property and equipment,
- inspection of supporting documentation, such as invoices, and
- recalculations of amounts, such as interest income.

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<sup>20</sup>OMB Bulletin 98-08 was effective for audits of federal departments' and agencies' fiscal year 1999 financial statements. OMB has issued new guidance, OMB Bulletin 01-02, effective for fiscal year 2000 financial statement audits.

<sup>21</sup>Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

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In our review of the auditor's working papers for the NASA fiscal year 1999 audit, we did not see evidence of a sufficient understanding of the internal control process relative to budgetary execution to support the extent of reliance Arthur Andersen placed on internal controls. An auditor's understanding about a particular type or group of transactions is often documented in a "cycle memorandum." We did not see evidence of a complete cycle memorandum or similar documentation of the auditor's understanding of the budget execution process in the Arthur Andersen working papers. Arthur Andersen's files did contain flowcharts prepared by NASA for both the budget formulation and budget execution processes; however, the working papers did not describe the internal controls that management represented were in effect. In addition, the flowcharts pertained to one NASA center and did not address the entire agency (all nine centers and headquarters). We found no documentation in Arthur Andersen's working papers relating to NASA's ad hoc process described earlier. In our follow-up meetings, the Arthur Andersen management team responsible for the NASA audit told us that they were not aware of NASA's ad hoc process for the Recoveries line item until June 2000, after the SBR misstatement was identified by the Committee and subsequently investigated. A complete understanding of NASA's ad hoc process could have resulted in specific audit steps designed to determine whether the Recoveries line was fairly stated.

Arthur Andersen identified two risks affecting the SBR. The first was the risk that transactions recorded in the system would not be captured in the SF 133. The second was the risk that commitments and obligations would exceed allotments. However, several additional risks are associated with the SBR, including the risk that reported undelivered orders have been delivered, and the risk that items that should be deobligated are not accurately reflected in NASA's accounting and reporting system.

In addition, for the fiscal year 1999 audit, Arthur Andersen identified the two budget risks at NASA headquarters only. The auditors concluded, based on representations by NASA management, that the controls were designed and operating effectively at headquarters and the nine centers. We determined from reviewing other working papers that, in the accounting and reporting environment at NASA in the period under review, the budget execution process occurred at the individual center level, as well as at headquarters, and that each center is subject to a different internal control environment. We found no evidence in Arthur

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Andersen's working papers that controls were tested to validate management's representations. Auditing standards<sup>22</sup> state that inquiry alone is not sufficient to support a conclusion about the effectiveness of design or operation of a specific control. "When the auditor determines that a specific control may have a significant effect in reducing control risk to a low level for a specific assertion, he or she ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control." As a result, we believe that Arthur Andersen had an insufficient basis to rely on NASA's budgetary controls.

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## Sufficient Evidential Matter

GAGAS fieldwork standards require an auditor to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under audit. In addition, SAS No. 56, Analytical Procedures, provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. Analytical procedures can be used to obtain evidential matter about particular assertions (e.g., completeness, existence, and valuation) related to account balances<sup>23</sup> or classes of transactions. The procedures involve comparison of recorded amounts or ratios developed from recorded amounts to expectations developed by the auditor. The auditor develops such expectations by identifying the plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Ordinarily, the results of analytical procedures alone are not sufficient to provide the desired level of assurance for a significant account balance or a major assertion on the financial statements. The auditor's reliance on substantive tests to achieve an audit objective related to a major assertion on the financial statements is more commonly derived from a combination of detailed tests of transactions and analytical procedures.

We found limited evidence of any testing of internal controls or underlying data relating to key balances on the budgetary statements. Instead, Arthur Andersen relied on analytical procedures to support key budgetary

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<sup>22</sup> AICPA Codification of Statements on Auditing Standards, AU sections 319.68 and .69.

<sup>23</sup> Testing of the reasonableness of account balances or amounts in financial statements is commonly referred to as substantive testing. This is in contrast to testing of the internal controls related to a particular account or balance.

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balances, such as Recoveries and \$2.2 billion of Undelivered Orders.<sup>24</sup> Moreover, Arthur Andersen's analytical procedures were inadequate and did not meet the requirements of SAS No. 56. Specifically, this standard requires that significant differences be investigated and any explanation of the differences by management be corroborated. In planning the analytical procedures as a substantive test, the auditor is to consider the amount of the difference from the expectation that can be accepted without further investigation. The auditor then needs to evaluate the significant unexpected differences. SAS No. 56 states that, while "inquiry of management may assist the auditor," management responses should be "corroborated with other evidential matter."<sup>25</sup> Further, SAS No. 56 requires that "in those cases when an explanation for the difference can not be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a likely misstatement."

However, Arthur Andersen's analytical procedures on the SBR line items did not use expectations. Further, the auditor's working papers documenting the analytical review procedures did not include any evidence of corroboration of management's statements with independent evidential matter. Specifically, the Arthur Andersen documentation of its analytical review of the "Recoveries of Prior Year Obligations" line consisted of the following:

"Recoveries of Prior Year Obligations increased by \$685,805 million [sic]. Amount represents amounts that were deobligated from prior obligations. NASA was not able to determine this amount in the prior year, therefore, the balance in this account in FY98 was \$0. The recoveries from prior year amounts are deducted from obligations incurred to arrive at obligations incurred (net). The amount from prior year is included in the Obligations Incurred (net) amount. Therefore, the obligations incurred (net) amount in the prior year is higher than in the current year."

This paragraph from Arthur Andersen's working papers documents statements by management to Arthur Andersen and represents all the documentation we found to support the audit procedures performed on the Recoveries line item of \$686 million reported for fiscal year 1999 in

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<sup>24</sup>Undelivered orders is a key balance relating to several lines of the SBR and Statement of Financing. Undelivered orders represent the value of goods and services ordered that have been obligated but have not been received.

<sup>25</sup>*AICPA Codification of Statements on Auditing Standards*, AU section 329.21.



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NASA's SBR. This explanation raises questions not only about the fiscal year 1999 Recoveries balance but also the fiscal year 1998 balance. Specifically, as indicated in Arthur Andersen's documentation for the explanation of the large variance in the Recoveries line on the SBR from the prior year, NASA management stated that it was not able to determine the amount in fiscal year 1998. This explanation calls into question the accuracy of the amounts as reported in fiscal year 1998, the first year for which the SBR was prepared. Given this information, Arthur Andersen should have performed further testing to validate the fiscal year 1998 balance because its audit opinion covered the comparative financial statements issued for fiscal years 1999 and 1998. However, no further testing of the fiscal year 1998 balance was performed.

In our follow-up meetings with Arthur Andersen auditors, we discussed the analytical procedures they used and attempted to confirm whether or not additional detail tests were performed for the fiscal year 1999 reported amount. The auditors stated that they traced the Recoveries line item amount on the SBR back to the source document, which they determined was the SF 133, although this audit step is not documented in the working papers. The SBR is prepared from the same information used to prepare the SF 133. The Arthur Andersen auditors added that they felt comfortable with the number as stated because management had prepared similar statements (SF 133s) in the past. However, we found that NASA had never reported an amount for Recoveries in its prior SF 133s. Again, no detail tests of underlying data were performed to verify the reasonableness of management's explanation.

We also did not see any evidence of testing by Arthur Andersen of NASA's reported \$2.2 billion of Undelivered Orders, a key budgetary balance. The Recoveries line on the SBR reflects the amount of reductions in prior-year unliquidated obligations, which include Undelivered Orders and Accounts Payable. Undelivered Orders are also a key component of other line items in the SBR and Statement of Financing. No audit procedures were performed to determine whether internal controls were properly designed and in place or to substantiate the balance of Undelivered Orders at year-end. Audits of other federal agencies have shown that accurate reporting of budget execution data and Undelivered Orders, in particular, has been a problem. Budget execution data is an area with a high risk of misstatement for many federal departments and agencies that therefore warrants audit scrutiny in the federal environment, as the following examples illustrate.

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## Audit Procedures on NASA's Revised SBR

- During our audit of IRS' fiscal year 1999 financial statements, we found that IRS internal controls were inadequate to provide reasonable assurance that the budgetary balances reported on its financial statements were reliable or that its obligations did not exceed budgetary resources.<sup>26</sup> Our testing of a statistical sample of 130 undelivered orders at September 30, 1999, found errors in 55 cases (42 percent). Specifically, we found undelivered orders dating back as far as 1996 that IRS should have deobligated.
- Audit results showed that for the Air Force Working Capital Fund, approximately \$211 million out of approximately \$1 billion in unliquidated obligations tested (700 out of 2,526 transactions tested) were incorrect, inadequately supported, or not supported.<sup>27</sup>
- Audit work also disclosed a material weakness in the Department of State's internal control process related to its management of unliquidated obligations, citing unsupported obligations and the lack of a structured process to reconcile and deobligate funds in a timely manner.<sup>28</sup> A review of \$279 million of unliquidated obligations that had no activity during fiscal year 1999 disclosed that 47 percent (\$132 million) should have been deobligated.

It is important to note that the previous discussion focuses primarily on the SBR amounts and audit procedures related to them as originally reported in NASA's Fiscal Year *1999 Accountability Report*. You also asked whether the revised SBR amounts submitted to the Committee on Science by NASA's Associate Administrator for Legislative Affairs on September 21, 2000, are reliable. The revised information was a representation from NASA management and was not subject to independent audit by either Arthur Andersen or the NASA IG before being reported to the Committee. However, NASA IG officials told us that they asked Arthur Andersen to verify the revised fiscal year 1999 SBR amounts as part of NASA's fiscal year 2000 audit, which was not complete at the time of our review.

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<sup>26</sup> *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, February 29, 2000).

<sup>27</sup> *Opinion on Fiscal Year 1999 Air Force Working Capital Fund Financial Statements*, Air Force Audit Agency, Audit Report 99068011, February 9, 2000.

<sup>28</sup> *Audit of the Department of State's 1999 and 1998 Principal Financial Statements*, United States Department of State, Office of the Inspector General, Audit Report 00-FM-022, August, 2000.

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As stated in our scope and methodology section (see appendix I), we were not asked to and did not perform audit procedures to support an expression of opinion as to whether the revised numbers are fairly stated in all material respects. Typical tests we perform to verify SBR amounts have included detailed transaction-based testing of a statistical sample of key budgetary balances and activities, as previously discussed. Auditing the SBR is a complex process and an area in which we have received several requests for guidance. To address that need, we will issue an Audit Alert<sup>29</sup> to provide more explicit guidance on auditing the SBR.

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**Auditor Did Not Identify Possible FFMLA Implications of Ad Hoc Procedures for Budgetary Information**

The systems deficiencies that led to the SBR error and Arthur Andersen's lack of understanding of the ad hoc process used by NASA to work around these deficiencies also raise questions about Arthur Andersen's conclusions that NASA's systems comply substantially with FFMLA. FFMLA requires that agencies implement and maintain systems that substantially comply with

- federal financial management systems requirements (FFMSR),<sup>30</sup>
- applicable generally accepted accounting principles, and
- the U.S. Standard General Ledger (SGL) at the transaction level.

The error in the SBR raises questions related to all three FFMLA requirements.

FFMSR call for systems to provide timely and useful information and report events and transactions according to the accounting classification structure and within the given accounting period. The Report on Budget Execution and Budgetary Resources (Standard Form 133) can serve as a principal source of information for the SBR and is prepared and reported quarterly to OMB. NASA did not use the ad hoc year-end data call to generate the Recoveries line of the SBR and Standard Form 133 during

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<sup>29</sup> Audit Alerts are nonauthoritative guidance we issue intended to provide auditors of federal government departments and agencies with information that will help them improve the efficiency and effectiveness of their audits. Audit Alerts are based on existing professional literature and the experiences of members of the federal government audit community.

<sup>30</sup> The Joint Financial Management Improvement Program (JFMIP) has issued two documents that address federal financial management system requirements: *Framework for Federal Financial Management Systems* (FFMSR-0, January 1995) and *Core Financial System Requirements* (FFMSR-1, September 1995).

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fiscal year 1999 or at any time during the prior 3 fiscal years. As a result, NASA's systems did not produce information in a timely or useful manner to support accurate reporting of key budgetary data as called for by FFMSR. In addition, the year-end data call was necessary because NASA did not have the SGL accounts to capture certain budgetary execution data that are required for the SF 133 and SBR. FFMSR state that systems must use the SGL chart of accounts as the basis for preparing external reports to OMB and Treasury. Because NASA did not have the SGL accounts required for Recoveries, its systems did not support timely and accurate reporting of information in the Standard Form 133 to OMB for fiscal years 1996 through 1999 as called for by FFMSR. In addition, the error in NASA's SBR for fiscal year 1999 resulted in financial statements that were not prepared in accordance with generally accepted accounting principles.

We reviewed Arthur Andersen's working papers supporting its assessment of NASA's FFMIA compliance. In these working papers, we found a memorandum written by NASA's CFO personnel acknowledging the financial management system deficiencies (for example, nonintegrated systems) and discussing numerous work-arounds and manual processes that, in management's opinion, enabled the agency to be in substantial compliance with FFMIA. That working paper included a handwritten note by an Arthur Andersen staff member documenting a telephone conversation with an OMB staff member. According to the note, the OMB staff member advised Arthur Andersen that "an agency would be in substantial compliance with the U.S. SGL requirements if the agency can 'cross-walk' its accounts to the SGL." At the time of this conversation, however, Arthur Andersen was unaware that NASA was using the ad hoc process to generate a year-end number. Because the Recoveries amount was generated through a data call and thus not produced by the use of specific NASA accounts, the issue of crosswalks to the SGL is not relevant. We found no further documented evidence that supported Arthur Andersen's conclusion on FFMIA compliance.

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## NASA IG Responsible for Audit Oversight

The NASA IG letter transmitting Arthur Andersen's report to the NASA Administrator and Chief Financial Officer included in the Fiscal Year 1999 *Accountability Report* stated that the NASA IG did not accept responsibility for expressing an opinion on NASA's financial statements for 1999 and 1998 and that the auditor's report was the responsibility of Arthur Andersen. The NASA IG reviewed Arthur Andersen's working papers and audit reports and reported that, in its opinion, Arthur Andersen's working papers and audit reports "complied in all material

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respects with applicable standards and mandated requirements.” The report also stated that the NASA IG monitored the progress of the audit at key points and reviewed Arthur Andersen’s report and related working papers to ensure compliance with applicable standards.

Inspector general responsibilities for audits, such as the NASA financial statement audit (conducted by Arthur Andersen under contract to the NASA IG), are identified in the Inspector General Act of 1978, as amended; the CFO Act of 1990, as expanded by GMRA; and OMB Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*. In fulfilling its responsibilities for the fiscal year 1999 financial statement audit, the NASA IG performed a quality control review of the audit by Arthur Andersen using a detailed checklist based on GAGAS. According to the checklist, the objectives of the NASA IG quality control review were to:

- ensure that the independent public accountant conducted the audit in accordance with applicable auditing standards (e.g., GAGAS) and OMB bulletin requirements,
- identify any follow-up work that needs to be done by the independent public accountant, and
- identify issues (either by the independent public accountant or the IG) that may require management attention.

We reviewed the NASA IG’s documentation of its work to monitor the quality of the audit work performed by Arthur Andersen. In completing its quality control checklist, the NASA IG reviewed Arthur Andersen’s internal control documentation. We found that the NASA IG staff made several notes questioning specific areas within certain processes. In addition, the NASA IG staff reviewed the one-paragraph working paper on Arthur Andersen’s analytical procedures related to the SBR that identified a large variance between the amount reported on the fiscal years 1998 and 1999 balances for the Recoveries line. The NASA IG’s working papers did not include any documentation that would indicate that the NASA IG staff questioned the adequacy of the work performed on NASA’s budgetary statements.

The NASA IG checklist also indicated that Arthur Andersen had tested FFMIA compliance. We did not see any evidence that the NASA IG staff questioned the limited nature of Arthur Andersen’s work to assess FFMIA compliance. As noted earlier, Arthur Andersen’s documented support for its FFMIA assessment consisted of a memorandum written by NASA

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management and a discussion with an OMB official and did not indicate any testing related to FFMIA.

In our discussions, the NASA IG staff indicated that they had recently issued a Request for Quotes (RFQ) to solicit a contractor to perform future NASA financial statement audits. As noted previously, fiscal year 2000 is the final year in Arthur Andersen's 5-year contract. To improve the quality and consistency of future audits, the RFQ specifies that the independent public accountant must perform the audits in accordance with the *GAO Financial Audit Manual*.<sup>31</sup> If properly implemented, use of the manual would improve the quality of NASA's future financial statement audits.

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## Conclusions

The budgetary statements, where the NASA misstatement occurred, if reliable, can provide information that can be used to assess the costs of prior-year agency activities and make decisions about future funding. As we noted, preparation of these relatively new budgetary statements, which are unique to the federal government, presents challenges to both the agency in accumulating the needed data and to auditors in rendering their opinion on whether the statements are fairly presented. NASA management, its independent auditors, and the NASA IG all play a critical role in ensuring that the relevant accounting and auditing standards and related guidance are followed for these important statements.

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## Recommendations

To ensure that NASA's strengthened procedures over financial statement preparation are in place and operating as intended, we recommend that the NASA Chief Financial Officer review the effectiveness of the enhanced procedures for the fiscal year 2000 reporting process and modify the procedures as necessary.

In addition, we recommend that the NASA IG review its overall quality control procedures for monitoring the work of independent public accountants and strengthen its procedures where appropriate, including

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<sup>31</sup>The *GAO Financial Audit Manual* is currently being revised under a joint effort of GAO and the President's Council on Integrity and Efficiency and will be called the *GAO/PCIE Financial Audit Manual*. It provides a methodology for compliance with professional auditing standards, guidance published by OMB, and relevant statutes. The final version is to be issued in May 2001 and is intended to be used as the primary guide for agency financial statement audits conducted by the IG community and GAO, beginning with the audits of fiscal year 2001 financial statements.

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updating the quality control checklist to incorporate the requirements of the *GAO/PCIE Financial Audit Manual* to monitor whether the independent public accountant's work was performed in accordance with relevant professional standards and guidance.

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## Comments and Our Evaluation

We obtained written comments on a draft of this report from the NASA Administrator, the NASA Inspector General, and the Arthur Andersen Engagement Partner who had responsibility for the fiscal year 1999 NASA financial statement audit. NASA management's comments are reprinted in appendix II, and the NASA IG and Arthur Andersen comments are reprinted in appendix III.

In commenting on a draft of this report, NASA management concurred with our conclusion regarding the misstatement in the fiscal year 1999 SBR. NASA also stated that it was, and continues to be, in substantial compliance with the requirements of FFMIA. Further, NASA management concurred with our recommendation that its strengthened procedures over financial statement preparation be reviewed for the fiscal year 2000 reporting process. The NASA IG stated that it has taken steps to strengthen its oversight of NASA's financial statement audits. In addition, the NASA IG concurred with our recommendation that the requirements of the *GAO/PCIE Financial Audit Manual* be incorporated in the IG's quality control process for future audits.

However, Arthur Andersen and the NASA IG disagreed with our analysis in most areas. Arthur Andersen stated that it believes that our conclusion concerning the adequacy of its work on the 1999 NASA audit is fundamentally incorrect. The NASA IG also disagreed with our conclusion on the adequacy of Arthur Andersen's audit work on the 1999 SBR and Statement of Financing. As discussed in the following sections and in our additional evaluation in appendix III, we believe that our conclusion is correct and disagree with the positions of Arthur Andersen and the NASA IG.

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## NASA Management Comments

NASA management concurred with our conclusion that the misstatement in the fiscal year 1999 SBR was caused, in part, by a misinterpretation of guidance for the preparation of the SBR and errors in the process for generating certain budgetary data. NASA also noted that it had strengthened its controls over the preparation of its financial statements for fiscal year 2000 and concurred with our recommendation to review

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these enhanced procedures and modify them as necessary. NASA also stated that the deficiencies in its general ledger and the SBR reporting error are of such a nature that NASA was, and continues to be, in substantial compliance with FFMIA.

Although we did not review NASA's enhanced controls over preparation of its fiscal year 2000 financial statements, we are pleased that NASA has adopted our recommendation and is evaluating the effectiveness of these controls based on a review of the fiscal year 2000 process. The scope of our review of the 1999 NASA audit was not sufficient for us to conclude whether NASA's systems substantially complied with the requirements of FFMIA. However, we believe that the inability of NASA's systems to routinely and reliably report information on the Recoveries line of the SBR raises serious questions about whether NASA's systems comply with FFMIA. If NASA's systems had accurately accumulated the appropriate transactions in the required general ledger accounts during fiscal year 1999, the ad hoc process that resulted in the \$1.3 billion of errors in NASA's SBR would not have been necessary.

NASA's response to our draft report also included a number of technical comments, which we have incorporated in the report as appropriate.

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## Arthur Andersen and NASA IG Comments

Arthur Andersen's and the NASA IG's comments fall into four general areas—the sufficiency of Arthur Andersen's work, the nature and significance of the SBR error, GAO's role regarding the 1999 NASA audit, and compliance of NASA's systems with FFMIA.

### Sufficiency of Arthur Andersen's Work

Arthur Andersen and the NASA IG concluded that the fiscal year 1999 audit work on the SBR and Statement of Financing was adequate and met all professional standards. They further noted that exercising due professional care does not guarantee that every error in financial statements will be detected and that an audit does not imply infallibility on the part of the auditor or the audit organization. The NASA IG further stated that a single error in auditor judgment does not rise to the level of violating auditing standards. Arthur Andersen and the NASA IG both stated that we did not adequately consider what they considered to be the justifiable reliance placed on the extensive testing of NASA's internal controls and processes and the substantial testing and sampling of financial data underlying the SBR and Statement of Financing in the previous years of the audit. Arthur Andersen noted that professional standards expressly permit auditors to use testing of controls from prior



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audits as long as they “obtain evidence about the nature and extent of significant changes in policies, procedures and personnel since they last performed those tests.” Arthur Andersen and the NASA IG stated that the “low” risk assessments and “scaling back” of its testing of the SBR and Statement of Financing for fiscal year 1999 were reasonable given what they considered to be the extensive prior-year audit work and the fact that the audit team was aware of no significant changes in policies, procedures, and personnel since the prior-year testing.

We agree with Arthur Andersen and the NASA IG that an audit does not imply infallibility on the part of the auditor or the audit organization or guarantee that there are no errors in the financial statements. Our view of the audit of NASA’s fiscal year 1999 SBR and Statement of Financing is based not on the presence of a mistake but rather on the lack of evidence in Arthur Andersen’s working papers. Specifically, we believe that Arthur Andersen’s working papers, including the 1996, 1997, and 1998 working papers we were provided—relating to understanding and testing internal controls and validating underlying data for key financial statement balances—were not adequate to support unqualified audit opinions on the fiscal year 1999 SBR and Statement of Financing. We found Arthur Andersen’s audit was characterized by excessive reliance on representations by NASA management, which led to an inappropriate assessment of risk related to the budgetary statements and resulted in the absence of any independent validation of underlying data for key balances supporting the fiscal year 1999 SBR and Statement of Financing.

For example, in its comments, Arthur Andersen stated that it had conducted “extensive testing of the SF-133s—the budget report from which the SBR is principally derived—and that such testing gave Andersen reasonable assurance regarding the internal controls relating to the SF-133s and thus on the integrity of the information in the SF-133s themselves” and went on to say that they “did precisely what GAGAS require in this setting—it reexamined the internal controls that had been in place in prior years and produced accurate SF-133 data to ensure that they were still effective.” It is important to note that we asked for and were provided what Arthur Andersen represented to us were all working papers from its fiscal year 1996 through 1999 audits that supported its conclusions on the fiscal year 1999 SBR and Statement of Financing. The facts documented in Arthur Andersen’s fiscal year 1999 and prior-year working papers do not support Arthur Andersen’s position.

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The following excerpt from a working paper documenting the results of Arthur Andersen's testing of NASA's SF 133s for fiscal year 1997 supports our conclusion that Arthur Andersen did not have a sufficient basis to conclude that controls over the budgetary process were effective.

"In reviewing NASA's process related to the preparation of the SF 133, AA has concluded that there are no high-level controls in place that ensure proper and accurate preparation of the SF 133 that are amenable to testing. As a result, AA has decided to test this process by tracing all information reported on the SF 133 to its source (e.g., general ledger reports)."

In this case, Arthur Andersen did not perform substantive testing of the underlying data that were reported on the SF 133, despite its finding of the lack of an adequate control environment over the SF 133 process. Instead, Arthur Andersen compared the management-prepared SF 133s to management's own general ledger. Such a comparison can determine whether clerical errors were made in transferring the data from its general ledger source to the required reporting format in the SF 133, but cannot offer any independent validation of the reported amounts. After tracing the SF 133 data to the NASA general ledger, Arthur Andersen then concluded that "NASA's control process over the preparation of the SF 133 is effective to prevent the occurrence of material misstatements." Arthur Andersen's conclusion on the SF 133s is an example of a process that was reviewed but not validated, a problem we identified throughout Arthur Andersen's working papers.

In addition, although Arthur Andersen stated that it reexamined the internal controls that had been in place in prior years to ensure they were still effective, we found that NASA's SF 133s for fiscal years 1996 through 1998 did not record any amount for Recoveries—the line item in question. Therefore, it would not have been possible for Arthur Andersen to have reexamined the controls over an amount that had not previously been reported. With fiscal year 1999 being the first year that NASA attempted to report the Recoveries amount, this appears to be a significant change in policies and procedures that would have precluded reliance on prior-year testing, even if that testing had been adequate.

Our findings of Arthur Andersen's inadequate testing of internal controls are further supported by the fact that the audit management team did not become aware of the ad hoc process used by NASA beginning in fiscal year 1999—a new procedure that again would have precluded reliance on prior-year testing—until after the Committee discovered the error in June 2000. Further, the NASA IG's response to our draft report stated that

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Arthur Andersen detected that NASA did not report Recoveries the very first year (1998) NASA was required to prepare the SBR. This contradicts Arthur Andersen's conclusion that the SF 133 process for fiscal year 1998 was reliable. The NASA IG further stated that Arthur Andersen orally advised NASA to report the Recoveries in the 1998 SBR. The NASA IG further stated that NASA management informed Arthur Andersen that it could not report this information because it did not have enough time, but agreed to report Recoveries in fiscal year 1999. Arthur Andersen issued its unqualified opinion for fiscal year 1998 without any evidence of the potential magnitude of this reporting issue. Further, although Arthur Andersen knew from its fiscal year 1998 work that NASA needed to develop a new procedure to obtain the information needed to report Recoveries, it accepted management's representation one year later, without independently validating the reported 1999 Recoveries balance of \$686 million versus \$0 reported in fiscal year 1998. Despite these facts, Arthur Andersen issued an unqualified opinion for fiscal year 1999 on comparative (fiscal year 1998 and 1999) financial statements.

Based on the above discussion, we disagree with Arthur Andersen and the NASA IG that the "low" risk assessments and "scaling back" of its testing of the SBR and Statement of Financing in fiscal year 1999 were reasonable because of its extensive prior-year work and the fact that the audit team was not aware of any significant policy changes. The fiscal year 1999 and prior-year working papers provided to us by Arthur Andersen clearly demonstrate that not only was the audit work on the SBR and the Statement of Financing not extensive, but there was in fact no testing in some key areas. For example, as stated in our report, we found no evidence of testing by Arthur Andersen of NASA's reported \$2.2 billion in Undelivered Orders, a key budgetary balance that affects several line items on the SBR and Statement of Financing. Arthur Andersen stated that it sampled disbursements and reconciled unobligated balances disclosed in the footnotes to the disclosure of Funds Held with Treasury, and, in turn, reconciled Funds Held with Treasury to NASA reports submitted to Treasury and generated by NASA's general ledger. Similar to Arthur Andersen's testing of NASA's fiscal year 1997 SF 133 process, its work on unobligated balances simply entailed reconciling one management-prepared report to another, with no independent testing of the underlying data.

Arthur Andersen's comments and what it describes as audit work show a fundamental misunderstanding of what is required to audit the SBR and Statement of Financing and demonstrate that its "low" risk assessment and

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“scaled back” testing were inappropriate. Specifically, unobligated balances are a derived number with no transaction-based support. As a result, it is not possible to test underlying data or audit the information except through testing of areas such as Undelivered Orders. Arthur Andersen’s comments demonstrate that it treated Undelivered Orders as a derived number (e.g., net of disbursements and unobligated amounts), which supports our conclusion that Arthur Andersen performed no testing of the \$2.2 billion of Undelivered Orders at September 30, 1999. As stated in this report, audits of other federal entities have included extensive statistical sampling of year-end transaction-based support for Undelivered Orders. This extensive sampling has shown that Undelivered Orders are at a high risk of misstatement for many federal departments and agencies. At IRS, for example, as a result of our fiscal year 1999 audit work that determined that Undelivered Orders were materially misstated, IRS management was able to substantially improve the reliability of its financial statements for Undelivered Orders for fiscal year 2000.

#### Nature and Significance of the SBR Error

Arthur Andersen and the NASA IG characterized the misstatement in the fiscal year 1999 NASA SBR as a misinterpretation by NASA management of OMB guidance in preparing the Recoveries line on the SBR. They further stated that the error was not material and that the SBR and Statement of Financing have been the source of substantial confusion among federal agencies and their auditors.

We agree with Arthur Andersen and the NASA IG that the preparation and audit of the SBR and Statement of Financing have been a significant source of confusion to agencies and their auditors. However, this confusion and the newness of these statements further demonstrate that Arthur Andersen’s “low” risk assessments and “scaling back” of its testing of the SBR and Statement of Financing for fiscal year 1999 were inappropriate. It is also important to note that the error in the Recoveries line was not the only error in the SBR. After we released our draft report for comment, NASA published final fiscal year 2000 financial statements, which included the audited revised fiscal year 1999 SBR. The final 1999 NASA financial statements show the \$644 million misstatement of the Recoveries line as well as the Obligations Incurred line item, which was also misstated by \$644 million. Thus, in aggregate, total misstatements in the final fiscal year 1999 NASA SBR were about \$1.3 billion.

We agree that the error was due, in part, to a misinterpretation by NASA CFO personnel. However, if NASA’s systems had appropriately captured the relevant information in the required general ledger accounts during

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fiscal year 1999, then the ad hoc process and resulting misinterpretation and error by NASA would not have resulted.

Neither Arthur Andersen nor the NASA IG's responses to our draft report mentioned the fact that the Recoveries error in the 1999 SBR was discovered by the House Science Committee while reviewing the NASA financial statements. Regarding materiality, it is defined as the magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the misstatement. The fact that the Committee discovered the discrepancy and asked NASA management whether \$686 million of Recoveries was actually available is a strong indicator that the \$644 million overstatement of Recoveries changed or influenced the Committee's judgment about the reliability of the SBR information. In addition, Arthur Andersen's response did not mention the fact that its documented materiality level for the 1999 NASA audit was \$150 million. Thus, the \$1.3 billion in errors in NASA's SBR was nearly 9 times greater than Arthur Andersen's own materiality threshold.

#### GAO's Role Regarding the 1999 NASA Audit

Arthur Andersen and the NASA IG took exception to the findings in this report stating that as part of our audit of the federal government's fiscal year 1999 consolidated financial statements we had previously reviewed Arthur Andersen's working papers relating to the fiscal year 1999 NASA audit. Arthur Andersen further stated that consistent with our original finding, Andersen's audit was properly planned, and as the NASA IG concluded, properly executed and reported. The NASA IG further stated that we had reviewed its quality control working papers related to its oversight of the NASA 1999 audit and that we had taken no exception to its oversight approach. We agree with Arthur Andersen and the NASA IG that we did review certain Arthur Andersen and NASA IG working papers from the fiscal year 1999 NASA audit as part of our audit of the federal government's consolidated financial statements. However, Arthur Andersen's and the NASA IG's characterization of the scope of our review and whether our review resulted in any conclusions on the sufficiency of Arthur Andersen's work is incorrect.

The SBR and Statement of Financing were not included in the fiscal year 1999 federal government's consolidated financial statements, and thus Arthur Andersen's working papers relating to the SBR and Statement of Financing were not relevant to our audit. These statements have not been prepared at the consolidated level but are prepared at the agency level.

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Further, we issued a disclaimer of opinion<sup>32</sup> on the federal government's consolidated financial statements and, therefore, made no conclusion on the reliability of any governmentwide financial information or on the reliability of NASA's financial statements or Arthur Andersen's audit.

Also, the purpose of our review of NASA and many other smaller federal agency financial audits was to determine whether findings from those audits were consistent with our governmentwide findings and should be considered in our reporting of the consolidated statements. As such, we did not review or take any position with regard to the quality of Arthur Andersen's audit on the SBR and Statement of Financing or on the NASA IG's oversight approach for these statements.

#### Compliance of NASA's Systems With FFMIA

Arthur Andersen and the NASA IG disagreed with our conclusion that the systems deficiencies that led to the SBR error and Arthur Andersen's lack of understanding of the ad hoc process used by NASA raise questions about whether NASA's financial management systems comply substantially with FFMIA. Arthur Andersen stated that its working papers were replete with testing procedures to ensure compliance with FFMIA.

We disagree with Arthur Andersen and the NASA IG. Specifically, the fact that NASA's systems did not have the required SGL accounts (accounts 4871 and 4971) to capture certain budgetary execution data and the resulting need for the ad hoc year-end data call raise questions about whether NASA's systems comply substantially with FFMIA.

Further, Arthur Andersen's working papers did not show that it performed extensive testing to support its conclusion that NASA's systems comply with FFMIA. For example, as stated in our report, the primary documented evidence in Arthur Andersen's working papers was a memorandum prepared by NASA CFO personnel, which acknowledged problems with NASA's systems, such as lack of a single, integrated financial management system and the use of alternative codes to the SGL. The memorandum then concluded that NASA's systems complied with FFMIA. Arthur Andersen supplemented this memorandum with handwritten notes documenting a telephone conversation between Arthur Andersen and an OMB staff member that, according to the note, "an agency would be in substantial compliance with U.S. SGL requirements if the agency can

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<sup>32</sup> A disclaimer of opinion means that we were unable to, and did not, express an opinion on the government's consolidated financial statements for fiscal year 1999.

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‘cross-walk’ its accounts to the SGL.” However, at the time of the discussion with the OMB staff member, Arthur Andersen was not aware that NASA was using the ad hoc process to develop a year-end number. We found no further documented evidence that supported Arthur Andersen’s conclusion on FFMI compliance and disagree that a memorandum from management and a telephone conversation with an OMB staff member constitute extensive testing. Rather, this type of evidence supports our conclusion that Arthur Andersen placed extensive reliance on unvalidated management representations.

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We are sending copies of this report to Senator John McCain, Chairman, and Senator Ernest Hollings, Ranking Member, Commerce, Science, and Transportation Committee, U.S. Senate; Representative Sherwood L. Boehlert, Chairman, and Representative Ralph M. Hall, Ranking Minority Member, Committee on Science, House of Representatives; Representative Bart Gordon, Ranking Minority Member, Subcommittee on Space and Aeronautics, Committee on Science, House of Representatives; and other interested congressional committees. We are also sending copies to the Honorable Daniel S. Goldin, Administrator, NASA; the Honorable Roberta L. Gross, Inspector General, NASA; the Honorable Mitchell E. Daniels, Jr., Director, Office of Management and Budget; the Honorable Paul H. O’Neill, Secretary, Department of the Treasury; and Graylin E. Smith, Engagement Partner, Arthur Andersen LLP. Copies will be made available to others upon request.

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Please contact me at (202) 512-9095 if you or your staff have any questions on this report. Key contributors to this report are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink, reading "Gregory D. Kutz". The signature is fluid and cursive, with the first name "Gregory" being the most prominent part.

Gregory D. Kutz  
Director  
Financial Management and Assurance



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# Appendix I: Objectives, Scope, and Methodology

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The objectives of this report were to review (1) the nature and causes of the discrepancy between NASA's Statement of Budgetary Resources (SBR) and Statement of Financing, including the adequacy of Office of Management and Budget guidance and related guidance available on the preparation of the SBR, (2) the adequacy of the auditing procedures performed by Arthur Andersen on the SBR and the Statement of Financing in NASA's fiscal year 1999 accountability report, and (3) the role of the NASA IG in overseeing Arthur Andersen's audit.

To fulfill these objectives, we reviewed documentation and interviewed NASA staff to determine how they accumulated, processed, and summarized data needed to prepare their fiscal year 1999 SBR and related budget documents. We also obtained an understanding of NASA's compilation process for its revised fiscal years 1999, 1998, and 1997 SBRs submitted to the House Committee on Science. We met with NASA officials and discussed their formal response to the Committee. We did not review the process of preparing the SBR for fiscal year 2000.

We reviewed applicable Treasury, Office of Management and Budget, and NASA guidance as well as related generally accepted accounting principles and concepts that related to budgetary accounting. We also reviewed applicable OMB, GAO, and AICPA standards related to federal financial statement audits.

We met with representatives from Arthur Andersen to discuss its audit of NASA's financial statements, which included the SBR and the Statement of Financing. We reviewed supporting working papers and made inquiries of managers and staff who performed the audit to identify Arthur Andersen's scope of work and to assess whether audit procedures related to the budgetary statements were adequate. We also interviewed Arthur Andersen's engagement partner on the NASA financial statement audit who left the firm prior to the issuance of Arthur Andersen's report on the fiscal year 1999 audit. However, consistent with the objectives of this review, we did not review any Arthur Andersen working papers related to the information systems control portion of the fiscal year 1999 audit. We also did not review the working papers related to Arthur Andersen's audit of NASA's fiscal year 2000 financial statements.

We met with NASA Inspector General officials to discuss their role in providing oversight of the financial audit. We reviewed working papers supporting the Inspector General oversight of the fiscal year 1999 financial

statement audit, such as audit programs, checklists, documentation of key meetings, and conclusions or summaries.

Because we did not audit NASA's financial statements, we do not express an opinion on the statements for fiscal years 1999 or 1998, as originally presented, or as restated in NASA's revised SBRs for fiscal years 1999, 1998, and 1997. Further, consistent with our objectives, as our review focused only on the audit of the budgetary statements, we cannot conclude on the adequacy of Arthur Andersen's work on the other principal statements, its report on internal control and compliance with laws and regulations, or whether NASA's systems comply substantially with Federal Financial Management Improvement Act.

We performed our work at NASA headquarters and NASA IG offices in Washington, D.C., and at Arthur Andersen LLP's offices in Vienna, Virginia, and Washington, D.C. We also reviewed documentation related to the solicitation and award of the audit contract at NASA's procurement offices at Goddard Space Flight Center in Greenbelt, Maryland. Our work was performed from October 2000 through February 2001 in accordance with generally accepted government auditing standards.

We requested written comments on a draft of this report from the NASA Administrator, the NASA IG, and the Arthur Andersen Engagement Partner who had responsibility for the fiscal year 1999 NASA financial statement audit. These comments are presented and evaluated in the "Comments and Our Evaluation" section of this report. In addition, NASA management's comments are reprinted in appendix II, and the NASA IG and Arthur Andersen comments are reprinted in appendix III.

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# Appendix II: Comments From NASA's Associate Deputy Administrator

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National Aeronautics and  
Space Administration  
**Office of the Administrator**  
Washington, DC 20546-0001



MAR 15 2001

Mr. Gregory D. Kutz  
Director, Financial Management  
and Assurance  
U.S. General Accounting Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Kutz:

We appreciate the opportunity to comment on the draft report on a misstatement that occurred in the National Aeronautics and Space Administration's (NASA) Fiscal Year (FY) 1999 Statement of Budgetary Resources (SBR). It is our understanding that copies of the draft report were also furnished to the NASA Office of the Inspector General and to Arthur Andersen, LLP, and they will provide their comments directly to you.

The draft report correctly concludes that the misstatement in NASA's FY 1999 SBR was caused by (1) a misinterpretation of guidance for the preparation of the SBR, and (2) errors in the process for generating certain budgetary data. Once NASA realized an error had occurred, the Agency's entire system of controls related to financial statement preparation was reviewed to ensure timely and accurate compilation and preparation of data in accordance with the Office of Management and Budget (OMB) and Department of the Treasury guidance. NASA's management controls include the following:

- Financial Management Manuals and NASA Policy Directives that provide a comprehensive framework of policies and procedures for ensuring a consistent and accurate implementation of Governmentwide regulations;
- A Quality Assurance Evaluation program that monitors Centers' compliance with the requirements of the NASA Financial Management Manuals and Policy Directives;
- Monthly reconciliations of Centers' financial data with Headquarters financial data. Feedback is provided to the Centers and followup analyses and documented resolutions are requested to ensure resolution;

- Statistical samples of Centers' data inputs to Headquarters. Reporting anomalies are identified, and correcting entries with explanations are input into the accounting system;
- Automated schedules to ensure the timely completion of steps in the financial statement preparation process;
- A detailed "Annual Accountability Report Preparation Procedures Manual" (ISO 9001 Certified) to ensure the continuity of the preparation process;
- Audit by an independent public accountant.

To strengthen the process for FY 2000 and thereafter, NASA instituted an independent verification and validation of data inputs to ensure accuracy and adherence to standard general ledger procedures. This process included a critique and verification of the contents of the financial statements by parties knowledgeable of Standard Ledger reporting requirements. In addition, NASA created and will maintain a file of procurement modifications that support the amounts reported as Recoveries of Prior Year Obligations. These modifications were sampled to confirm the accuracy of the data.

The draft report contains the following recommendation:

To ensure that NASA's strengthened procedures over financial statement preparation are in place and operating as intended, we recommend that the NASA Chief Financial Officer review the effectiveness of the enhanced procedures for the fiscal year 2000 reporting process and modify the procedures as necessary.

NASA concurs with this recommendation. On March 12, 2001, the Acting Chief Financial Officer initiated a review of the FY 2000 Accountability Report preparation process with emphasis on evaluation of the effectiveness of the strengthened procedures over financial statement preparation.

The draft report raises, but does not fully address, the issue of NASA's compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996. NASA was, and continues to be, in substantial compliance with the requirements of FFMIA.

The draft report states that, "In addition, the deficiencies in NASA's general ledger and the error in NASA's SBR described earlier raise questions about Arthur Andersen's conclusion that NASA's systems complied substantially with the requirements of FFMIA." As acknowledged in the draft report, NASA management prepared a memorandum that addressed NASA's compliance with FFMIA. The draft report does not recognize that the memorandum specifically addresses, on a point-by-point basis, how NASA satisfied the criteria for measuring compliance with FFMIA provided in Attachment D of OMB Bulletin No. 98-08. Based on the data provided in the

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memorandum, NASA concluded that the Agency was in substantial compliance with FFMIA. Arthur Andersen reached the same conclusion. While the draft report appears to cast some doubt on NASA's compliance with FFMIA, the draft does not reach a conclusion on the compliance issue. It is NASA's view that the two matters addressed in the draft report (deficiencies in NASA's general ledger and the SBR reporting error) are of such a nature that NASA continues to be in substantial compliance with FFMIA.

Comments of a technical nature are provided as an enclosure. If you have any questions, or require additional information, please contact Stephen J. Varholy, Acting Chief Financial Officer on 202-358-2262.

Sincerely,



Daniel R. Mulville  
Associate Deputy Administrator

Enclosure

# Appendix III: Comments From Arthur Andersen LLP and NASA's Inspector General

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



Mr. Gregory D. Kutz, Director  
Financial Management and Assurance Team  
United States General Accounting Office  
441 G Street, N.W., Room 5T57  
Washington, D.C. 20548

Arthur Andersen LLP  
8000 Towers Crescent Drive  
Vienna VA 22182-2725  
Tel 703 962 2100

Dear Mr. Kutz:

We appreciate the opportunity to provide comments on the February 2001 Draft Report, *Financial Management — Misstatement of NASA's Statement of Budgetary Resources, GAO/GAO-01-438* (the "Draft Report") and are hopeful that our comments will lead to further discussions concerning the content of the final report that will be issued by the General Accounting Office ("GAO").

See comment 1.

Simply put, we believe that the Draft Report's implicit, but unmistakable, conclusion concerning the adequacy of the work performed by Arthur Andersen LLP ("Andersen") in connection with the 1999 NASA audit is fundamentally incorrect.

GAO's conclusion appears to be premised on a misunderstanding of the documentation contained in Andersen's 1999 audit workpapers as well as a misapprehension of the audit plan executed by Andersen and the justifiable reliance that Andersen placed on its extensive testing of NASA's internal controls and processes in the previous years of its auditing engagement. Such a misunderstanding is quite surprising, in our view, in light of the fact that in January 2000 GAO reviewed Andersen's audit plan, risk analyses, and determinations concerning the level of audit testing required for 1999 and took no exception. In addition, GAO's review of Andersen's 1999 audit workpapers in conjunction with the GAO's audit of the U.S. Government's 1999 consolidated financial statements did not result in any comments or suggestions related to the nature, timing, or extent of audit work performed on NASA's budgetary statements.

See comment 2.

A complete review of all the work done by Andersen shows that its audit of NASA's 1999 financial statements complied fully with generally accepted government auditing standards ("GAGAS") and the various auditing bulletins that related to the auditing of financial statements in the federal government sector. Indeed, Andersen is not alone in this assessment. NASA's Office of Inspector General ("OIG"), which has oversight responsibility for ensuring the adequacy of the audit work performed over NASA's financial and budgetary statements included in NASA's Accountability Report, has itself found that Andersen "properly planned, executed, and reported the results of its audit" in accordance with government auditing standards. [*Quality Control Review Report, Arthur Andersen LLP Audit of the NASA Financial Statements for Fiscal Year Ended September 30, 1999, IG-00-022 (March 29, 2000) ("OIG Quality Control Review Report")*, at 1]

See comment 1.

GAO's new-found concern about Andersen's 1999 audit work has been triggered by the discovery of a reporting error on one line of the Statement of Budgetary Resources ("SBR") — Recoveries of Prior Year Obligations ("recoveries"). While NASA, the OIG, and Andersen all regret the reporting error for recoveries in the SBR, that error raises no inference of a lack of due professional care on the part of NASA management, the OIG or Andersen. This reporting error was not the product of a lack of due care, but rather the result of a good-faith misinterpretation of OMB guidance on the SBR — a budgetary statement that has been the subject of enormous confusion since its inception in 1998.

Mr. Gregory D. Kutz  
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See comment 3.

Moreover, the reporting error, which represented less than 5% of NASA's budgetary resources, had no net effect on reported Net Costs in NASA's 1999 Statement of Financing — the figure that best represents NASA's "bottom line" — and was corrected by NASA soon after it was discovered.

See comment 1.

In short, GAO itself was right the first time it examined the 1999 audit plan. Consistent with GAO's original finding, Andersen's audit was properly planned, and as the OIG concluded, properly executed and reported. Set forth below is a detailed summary of Andersen's audit work in 1999 and prior years that provided sufficient evidential support to give NASA an unqualified opinion on its 1999 budgetary statements and fully clarifies the circumstances surrounding the reporting error in the SBR that gave rise to this issue. In addition, we will explain why Andersen's workpapers provide sufficient evidential support for its opinion that NASA is in substantial compliance with the Federal Financial Management Improvement Act ("FFMIA").

I. Andersen's Audit Complied Fully with Professional Standards

See comment 1.

Having reviewed only Andersen's 1999 workpapers in evaluating Andersen's 1999 audit, the Draft Report states that "[e]vidence in [Andersen's] working papers relating to understanding and testing internal controls and validating underlying data for key financial statement balances was not adequate to support Andersen's unqualified audit opinion on the Statement of Budgetary Resources and Statement of Financing for fiscal year 1999." (*Draft Report at 4-5*) In reaching this conclusion, however, the Draft Report has failed to take account of (1) the significant internal controls assessment documented in the 1999 workpapers, (2) the substantial testing and sampling done in prior years on financial data (and accompanying internal controls) underlying the SBR and Statement of Financing, and (3) the analysis of the SBR in relation to NASA's proprietary financial statements.

See comment 4.

*Scope of Audit Work.* As part of planning for the 1999 audit, Andersen identified all material risks related to NASA. Included on this risk map are five risks related to NASA's budgetary process: (1) Budget and Planning Risk, (2) Capital Availability Risk, (3) Resource Allocation Risk, (4) Risk that Transactions in Subsidiary System are not reflected in the SF-133, and (5) Risk that Commitments and Obligations Exceed Allotments. For the five risks identified for NASA's budgetary process, Andersen created two risk control documents that reflect its evaluation of the internal controls in place related to these risks.

See comment 1.

These risk control documents refer to the workpapers that explain the design of the controls and document Andersen's assessment that the design of the controls was effective. In addition to the specific risk control documents concerning NASA's internal controls relating to budgetary data, the 1999 workpapers also contain a memorandum reflecting Andersen's audit methodology for 1999. This audit plan, including its risk analyses and determinations concerning the level of audit testing required for 1999, was reviewed by GAO in January 2000, and GAO took no exception.

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As part of its 1999 audit work, Andersen also visited the following Centers based on an assessment of materiality of each Center and the volume of transactions processed.

- Headquarters
- Langley
- Marshall
- Johnson
- Kennedy
- Goddard

Testing performed at these Centers focused on the accuracy of transaction processing in the areas of expenditures, payroll, reimbursable orders and property. These four areas impact NASA's budgetary processing and reporting.

In 1999, Andersen traced the line items contained in the SBR to the SF-133 — “the principal source of information for the SBR” (see Draft Report at 7)<sup>1</sup> — tied the total budgetary authority into Public Law and, to test NASA's compliance with the Closed Account Legislation, verified the appropriations balances that had been closed, which expired for obligational purposes at the end of fiscal year 1994.

The Statement of Financing is intended to reconcile the obligation-based Statement of Budgetary Resources to the accrual-based Statement of Net Cost. Therefore, the Statement of Financing is composed of reconciling items that can be directly tied to financial statement line items on NASA's proprietary financial statements (Statement of Financial Position, Statement of Net Cost, and Statement of Changes in Net Position). Andersen's audit workpapers indicate that the reconciling items on the Statement of Financing were agreed to the proprietary financial statement line items. In addition, Andersen's workpapers document extensive auditing procedures related to those proprietary financial statement line items.

While it is unclear whether the authors of the Draft Report considered all of the above-described work in reaching its conclusion about the sufficiency of Andersen's audit work, it appears that they failed to consider any testing or other audit work conducted by Andersen during prior years that bear upon the SBR and Statement of Financing. It is axiomatic that the adequacy of an audit cannot properly be evaluated in a vacuum. Governing professional standards expressly permit auditors to “use evidence

<sup>1</sup> “OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*, is the guidance used by agencies to prepare the SBR. Per OMB's guidance, the SBR illustrates in condensed form the information that OMB Circular A-34, *Instructions on Budget Execution*, requires to be reported on the SF-133, *Report on Budget Execution*.” *Federal Accounting and Reporting: Framework for Assessing the Reliability of Budget Execution Data is Not Yet Fully Implemented*, (GAO-01-43, October 2000) (“GAO Budget Execution Data Report”), at 11 n.14.

See comment 1.

See comment 5.



Mr. Gregory D. Kutz  
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from tests of controls done in prior audits (or at an interim date)," as long as they "obtain evidence about the nature and extent of significant changes in policies, procedures and personnel since they last performed those tests" (*GAGAS* § 4.32e. See also *GAGAS* §§ 4.21, 4.23, 4.31).

See comment 1.

A review of Andersen's audit work demonstrates that Andersen had conducted extensive testing of the SF-133s — the budget report from which the SBR is principally derived — and that such testing gave Andersen reasonable assurance regarding the internal controls relating to the SF-133s and thus on the integrity of the information in the SF-133s themselves. Moreover, in 1999, Andersen did precisely what GAGAS require in this setting — it reexamined the internal controls that had been in place in prior years and produced accurate SF-133 data to ensure that they were still effective. Andersen's 1999 workpapers also expressly state that, in auditing the budgetary statements, the audit team intended to rely largely on the SF-133-related testing conducted in prior years. As noted above, GAO reviewed Andersen's planning workpapers and took no exception to that approach.

The following is a summary of the testing and internal controls work conducted by Andersen between 1996 and 1998 (as evidenced by the workpapers for those years) in connection with the data contained in the SF-133 (and ultimately the SBR and Statement of Financing).

1996

- Visited the following Centers based on an assessment of materiality of each Center and volume of transactions processed.
  - Headquarters
  - Goddard
  - Kennedy
  - Marshall
  - Johnson
- Prepared memorandum on budget cycle.
- At each Center visited, tested key risks within the budget cycle.
  - Approval of obligations
  - Timeliness of recording of obligations
  - Availability of funds for commitments
- Exceptions were noted concerning timeliness of recording obligations at Headquarters and Goddard. Additional substantive testing was performed for these two Centers at year-end, and a recommendation was included in the Management Letter.
- For the supplemental budgetary schedule in the financial statements, compared data on schedule to FACS system and to the SF-133 to ensure no material discrepancies were present.

See comment 1.

Mr. Gregory D. Kutz  
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See comment 1.

1997

- Visited the following Centers based on an assessment of materiality of each Center and volume of transactions processed.
  - Headquarters
  - Goddard
  - Kennedy
  - Johnson
  - Ames
  - Lewis (now Glenn)
- Updated budget cycle memorandum.
- Prepared memorandum to document the decision to test the budget process at Headquarters based on the favorable results of the 1996 audit work.
- At each Center noted above, tested key risks within the disbursements cycle, such as the following.
  - Authorization of expenses
  - Reconciliations with Treasury
  - Comparing obligation documents to purchase requests
  - Timeliness of recording of obligations
- Testing of Headquarters budget processes involved the following.
  - Preparation of flowchart
  - Cycle memo on preparation of SF-133 report
  - Detailed testing of SF-133 report, including tracing to general ledger data
  - Testing of reconciliation of Headquarters budget data to Centers' data (designed to detect unauthorized programs)
  - Testing of resource authority documents to ensure that they did not exceed operating plan
  - Testing of whether Centers' obligations and commitments exceeded operating plan
  - Traced final SF-133 to "Executive Budget"

1998

- Visited the following Centers based on an assessment of materiality of each Center and volume of transactions processed.
  - Headquarters
  - Johnson
  - Kennedy

See comment 1.

Mr. Gregory D. Kutz  
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- Marshall
- Stennis
- Dryden
- At each Center noted above, tested key risks within the disbursements cycle, such as the following.
  - Authorization of expenses
  - Disbursements made against valid obligations
  - Reconciliations with Treasury
  - Obligation documents compared to purchase requests
- Budget cycle:
  - Updated memo and flowcharts on cycle.
  - Updated memo on SF-133 preparation process.
  - Tested documents supporting allocation of funding authority to NASA program offices.
  - Tested documents supporting allotment of funds to Centers.
  - Reviewed Headquarters budget system reports to ensure funding authority issued to Centers did not exceed funding authority issued to program offices.
  - Reviewed quarterly SF-133 report.
- Two of the sources of information for the SF-133 are the SF-224 *Statement of Transactions* and the monthly general ledgers submitted by the Centers. The audit team performed a substantial amount of work related to both of these sources.
- Statement of Budgetary Resources was reconciled to the SF-133 report.
- Reviewed the SF-224 reconciliations for all the Centers visited related to the Payroll and Revenue and Receipts Cycles. Ensured that reconciling items, if any, were reasonable and timely resolved.
- The monthly general ledgers submitted to Headquarters from the Centers are reconciled monthly to Treasury's report 6652 *Statement of Differences* by the Chief of the Accounting, Reporting and Analysis Branch. Reviewed this reconciliation in the same manner as the SF-224.

Based upon the favorable results from the extensive testing work in 1996 through 1998, the audit team, in its professional judgment, and as permitted under GAGAS, determined that the internal controls in place were sufficient to permit it to scale back its testing of SF-133-related data in 1999. In light of the fact that the audit team was aware of no "significant changes in policies, procedures and personnel since they last performed those tests" (GAGAS § 4.32e), that decision was a reasonable one. The recoveries line item was first reported on the SF-133 in 1999; however, NASA's process used to report information on the SF-133 had been evaluated in prior audits and was considered to be designed and operating

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effectively. Thus, Andersen had substantial evidential support to render its opinion that the 1999 SBR fairly presented NASA's budgetary resources in all material respects.

*Undelivered Orders.* In making its case that Andersen failed to conduct sufficient testing of "key balances on the budgetary statements" (Draft Report at 27), the Draft Report alleges that Andersen did not adequately examine "undelivered orders." This is not so. At the end of the fiscal year, appropriations can be divided into two broad categories: expended and unexpended. Expended appropriations relate to all amounts that have been recorded as expenses in the statement of net cost. Unexpended appropriations consist of undelivered orders, unobligated balances (available), and unobligated balances (not available). A risk exists related to properly distinguishing between an expended appropriation on the one hand and an unexpended appropriation on the other. To address this risk, NASA management performed disbursements testing at year-end in 1999 to ensure completeness and accuracy of amounts accrued. Andersen reviewed the results of that testing and repeated the testing on a sample of transactions. Since no exceptions were noted in the testing, the audit team reasonably concluded that the population of expended appropriations compared to unexpended appropriations was not materially misstated.

In addition, within unexpended appropriations, unobligated balances disclosed in the footnotes were reconciled to the disclosure of Funds Held with Treasury, and, in turn, Funds Held with Treasury were reconciled to NASA reports submitted to Treasury and generated from the general ledger. Thus, the Draft Report is simply mistaken when it states that Andersen relied only on "analytical procedures to support . . . undelivered orders" (Draft Report at 27). Andersen did test "undelivered orders" through its testing work on disbursements and its reconciliation of held Treasury funds with the general ledger.

II. The Sufficiency of Andersen's Work is Further Underscored by NASA's Inspector General's Conclusion that Andersen's Work was Performed in Accordance with GAGAS

Under the Inspector General Act of 1978, the OIG is required to conduct agency audits or oversee audits conducted by independent auditors under contract. Specifically, the OIG is to (OMB Bulletin 98-08, ¶ 10):

- ensure that the audit is performed and that the audit report is completed in a timely manner and in accordance with OMB Bulletin requirements;
- provide technical advice and act as a liaison between the agency and the independent auditors;
- perform quality control reviews and provide the results to interested organizations; and
- monitor and report on management's progress in resolving audit findings identified by independent external auditors.

NASA's OIG reviewed Andersen's "audit program and the testing of evidence to determine whether testing was sufficient, based on an assessment of control risk, to warrant the conclusion reached and whether the working papers supported the conclusion" (OIG Quality Control Review Report at 7).

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Since Andersen also is required to assess whether NASA's financial management systems substantially complied with FFMIA, the OIG also reviewed Andersen's audit programs for the appropriate procedures and the compliance testing performed. *Id.*

To fulfill its oversight responsibilities, the NASA OIG also monitored the progress of the audit at key points and performed other procedures as necessary. The OIG's involvement extended from the initial audit planning to execution and completion. The quality control review was conducted from June 1999 through March 2000.

At the end of this process, the OIG concluded that Andersen "properly planned, executed [and] reported the results of its audit" in accordance with governmental auditing standards. *Id.* The Draft Report makes no mention of the fact that the federal official with principal responsibility for ensuring the reliability of the audit process at NASA found that Andersen's audit work fully complied with professional standards.

### III. The SBR Reporting Error

Despite having complied with all statutory and professional obligations, NASA management and Andersen failed to detect a reporting error on one line item in the SBR — Recoveries of Prior Year Obligations. As the Draft Report notes, this error was largely attributable to NASA's mistaken inclusion of "disbursements of expired appropriations" — a NASA general ledger item — in the line item. In addition, a small portion of the overstated amount traced back to minor computational errors in compiling the amount of true "recoveries." This detailed re-examination of this line item in particular — and of the SBR in general — has confirmed that there were no errors or problems with the integrity of the underlying financial data. This error was simply a compilation error, primarily due to a misinterpretation of the components of the line item.

While the Draft Report correctly identifies the size of the error, it fails to consider (or makes reference only in passing) to several key facts that are essential to a full understanding of the nature of the overstatement and of the process that generated it. Specifically, (1) the reporting error in the SBR was not material (as that term is used in GAGAS), (2) the error was fully offset and thus had no net effect on Net Cost in the Statement of Financing or on any other of NASA's financial statements, (3) the recoveries line item error provides only limited information on available resources for funding future projects, and (4) the SBR and Statement of Financing only have recently become required statements (commencing with fiscal year 1998) and, as GAO has found, have been the source of substantial confusion among federal agencies and their auditors. Only by considering all of these factors can the reporting error be placed in the proper context.

*Materiality.* GAO itself states that "even though an unqualified audit opinion may be achieved, because of the use of materiality guidelines in determining the scope of the financial audit, complete assurance over all amounts presented is not pondered by the audit. In addition, unqualified opinions do not guarantee that agencies have the financial systems needed to dependably produce reliable financial information." *GAO Budget Execution Data Report*, at 13 It is well-established that "[a]uditors'

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consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements....” *GAO Government Auditing Standards* (1994), at 33, ¶ 4.8. As that standard suggests, there is no “bright line” quantitative rule for determining materiality; it is generally accepted, however, that an accounting adjustment may be appropriate if the impact of the change is greater than five percent of the unadjusted balance and is generally required where the adjustment exceeds 10 percent. Here, the \$644 million overstatement for recoveries constitutes less than five percent of NASA’s total budgetary resources. Thus, the impact of the error falls below even the lower end of the generally accepted range for materiality.

*Net Offset.* As important, the error in the recoveries line item was fully offset within the SBR so that Net Cost on the Statement of Financing – the government analogue to net income — was unaffected by the error. Thus, the error had no net impact on NASA’s actual budgetary resources. Further, the reporting error did not impact the key financial statements — Statement of Financial Position, Statement of Net Cost and Statement of Changes in Net Position. Indeed, because Obligations Incurred (Net) was not impacted by the overstatement, the error also had no net effect on Total Outlays on the SBR. Thus, taken as whole, the impact on NASA’s financial statements was minimal.

*The Limited Significance of the Recoveries Line Item.* The Draft Report contends that, as originally reported in the 1999 SBR, the recoveries “line item indicated to users of NASA’s budgetary reports that additional funds, which did not exist, were available for new obligations or to cover increases in existing obligations and could have been used to reduce needed funding.” (*See Draft Report at 3.*)<sup>1</sup> In fact, federal agencies’ ability to use recoveries of prior year obligations is far more complex than the Draft Report suggests. If the recovery involves an expired appropriation, the funds can only be used to cover increases in existing obligations. If the recovered obligation relates to an unexpired appropriation, then the funds may be used on new obligations only if the agency obtains the requisite approval from the Office of Management and Budget. Thus, contrary to the Draft Report’s suggestion, an appropriator would be wrong to assume that all funds recovered from prior year obligations could be used for new projects. In fact, only a small portion of those funds may be available for that purpose. The far more significant line item for determining NASA’s existing resources that could be applied to future projects is “Unobligated Balances — Available.” This line item was unaffected by the reporting error at issue.

*Other Federal Agencies’ Budgetary Reporting Errors.* In evaluating Andersen’s work, it is also important to consider (as the Draft Report does only in passing) that the SBR and Statement of Financing are of quite recent origin (1998), and that, as a consequence, there have been a number of errors detected in federal agencies audited budgetary statements. In May 1996, the Federal Accounting Standards Advisory Board (“FASAB”) — the recognized accounting standard-setting body for the U.S. Government — issued Statement of Federal Financial Accounting Standards No. 7 (“SFFAS 7”) to become effective

<sup>1</sup> As it turns out, because the error was detected in the early summer of 2000 prior to Congressional appropriations action, the reporting error could not have had any actual impact on the NASA appropriations process for FY 2001.

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for fiscal years after September 30, 1997. Among the new obligations imposed by SFFAS 7 was the presentation of two new statements — the Statement of Budgetary Resources and the Statement of Financing. As GAO itself has discovered, complying with SFFAS 7 has been a difficult task for many federal agencies. Indeed, the *GAO Budget Execution Data Report* made a number of important observations following its review of the agencies with 22 major budgetary statements. In particular, the report stated “[f]or three major budgetary accounts...where the agencies’ financial statements, including the SBR, were determined to be fairly stated by the auditors and we determined that budgetary information was reliable, we found *significant* differences between amounts in the SBR and the P&F Schedules (in the President’s Budget)....” *Id.* at 20 (emphasis added). The report further stated that OMB officials were cognizant of the confusion surrounding the newly required budgetary statements and that “they are currently revising the guidance for...financial statements and...other guidance...to address these differences. OMB’s goal is to *minimize* differences...” *Id.* at 21 (emphasis added). Thus, Andersen was not alone in rendering a clean opinion on budgetary statements that ultimately were determined to contain reporting errors.

See comment 11.

*The Recoveries Line Item Error and Andersen’s Audit.* It is undisputed that the 1999 reporting error was due to NASA financial management’s misunderstanding of the precise components of the Recoveries of Prior Year Obligations line item. Specifically, the bulk of the error (\$592 million), is attributable to NASA’s mistaken inclusion of the general ledger item “disbursements of expired appropriations” in the recoveries line item. The decision to include this item was based on a reference in OMB 97-01 (guidance for preparation of the SBR) to Recoveries of Prior Year Obligations as an “adjustment.” NASA personnel understood “disbursements of expired appropriations” to constitute an “adjustment,” and because the “disbursements” were not otherwise accounted for in the SBR, NASA personnel included that amount in the recoveries line item.

The remaining amount of the recoveries overstatement (\$52 million) was the result of confusion concerning the inclusion of specific data in the accounting system which constituted Recoveries of Prior Year Obligations. In particular, NASA requested that the Centers compile data that would be reported in the two standard general ledger accounts which, according to the Treasury’s Financial Manual guidance, comprised the recoveries line item. NASA management understood that, in an effort to comply with this guidance, the Centers — whose systems did not contain the general ledger accounts — had queried their accounting systems for negative transaction activity in obligation accounts. Those amounts were aggregated and included in the recoveries line item.

See comment 12.

Upon learning that there might be an error in the recoveries line item, NASA conducted additional research and discovered that there are many types of “negative obligation transaction activity” that do not constitute a true recovery of prior year obligations available for reobligation. Accordingly, NASA set about the task of extracting only the true recoveries from that negative transaction activity in the obligations account and provided the adjusted number (less “disbursements of expired appropriations”) to Congress. Overall, while the recoveries overstatement was the product of a NASA misinterpretation of imprecise OMB guidance concerning the preparation of the SBR, it was plainly not the result of underlying errors in NASA’s accounting records. It is equally clear that the error was not the

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result of a deliberate attempt by NASA officials to gain any advantage in the budget decision-making process.

See comment 1.

The Draft Report takes Andersen to task for not discovering NASA's good-faith misinterpretation of SBR guidance and the "ad hoc" procedures by the Centers to extract the recoveries line item (*see Draft Report at 22-24*). Exercising due professional care does not guarantee that every error will be detected, nor is this the standard to which an auditor is held. [See, e.g., *GAGAS § 3.30 (requirement that auditors exercise due care does not "imply infallibility on the part of either the individual auditor or the auditor organization")*]. As explained above, Andersen had gained reasonable assurance from its prior extensive testing on the SF-133-related data to limit the scope of its work in 1999 to tying the SBR to the SF-133, to Treasury balances, and appropriations laws. In conducting these procedures, Andersen noticed the variance in the recoveries line item between 1998 and 1999, and asked NASA personnel to explain the difference. As (1) NASA's methodology appeared reasonable, (2) Andersen had confidence in the integrity of the underlying data based on its extensive prior audit testing and internal controls work on the SF-133 – the source of the "recoveries" amount, (3) the recoveries line item tied to the SF-133, and (4) the recoveries line item was not considered a high risk item on NASA's budgetary resources since it did not impact total outlays or obligations incurred, Andersen determined it did not need to conduct additional work on that line item. While Andersen now regrets not further exploring NASA's procedures for gathering the relevant data, based on all of the information in its possession at the time, Andersen made a reasonable audit decision not to conduct additional work on the recoveries line item. This decision was concurred with by the OIG.

#### IV. FFMIA

See comment 1.

Finally, the Draft Report claims there is insufficient evidence in Andersen's workpapers to support its conclusion that NASA is in compliance with FFMIA (*see Draft Report at 31-32*). Moreover, the Draft Report states that the reporting error on the SBR and the fact that NASA does not utilize Standard General Ledger ("SGL") accounts for transactions cast significant doubt on NASA's compliance with FFMIA (*Id.* at 32). Such conclusions are incorrect.

See comment 13.

At the outset, Andersen's workpapers are replete with testing procedures to ensure compliance with FFMIA. The workpapers show that Andersen has tested NASA's compliance with FFMIA through extensive testing of the laws and regulations of the agency. Each audit year, Andersen has received a written memorandum from NASA's Chief Financial Officer addressing each requirement of the FFMIA and how NASA complies with these requirements. These representations, in turn, have been tested. For example, under FFMIA, federal agencies are required to use SGL accounts to record transactions. However, OMB guidance permits agencies to use alternative codes as long as there are crosswalks to the SGL accounts. NASA complies with the FFMIA requirement by using crosswalks to the SGL accounts. In 1996, Andersen reviewed and tested the crosswalk to ensure that it was properly prepared. Indeed, the workpapers reflect that, in 1997, Andersen consulted with OMB concerning NASA's utilization of certain crosswalks to ensure that they complied with OMB guidance. Each year thereafter, new accounts that had been added to the crosswalk were reviewed and tested and Andersen ensured that the new accounts



Mr. Gregory D. Kutz  
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complied with Department of Treasury guidance. This testing, together with other audit procedures performed, fully supports Andersen's FFMIA compliance opinion.

Second, since a federal agency can be in compliance with FFMIA with the use of crosswalks, the Draft Report is incorrect in asserting that absence of SGL accounts to record transactions demonstrates non-compliance with FFMIA. As long as the crosswalks are accurate, the agency does not violate FFMIA's requirements. Certainly the reporting error in the recoveries line item provides no evidence of FFMIA non-compliance. As explained in detail above, that error was the result of a misunderstanding concerning the subcomponents of that line item. That confusion has not the slightest bearing on NASA's FFMIA compliance.

V. Conclusion

We look forward to working together with GAO and the Inspector General to further refine and improve the audit process. While we regret the reporting error in the SBR, we remain steadfast in our belief that our 1999 audit fully complied with professional standards. Nevertheless, our audit of NASA as of and for the year ended September 30, 2000, included additional audit procedures to further validate the information reported on NASA's budgetary statements.

As we noted at the outset, we hope that our comments will spur further discussions so that, at the end of this process, the GAO report on this matter will be an accurate reflection of Andersen's work and of the circumstances that led to the reporting error.

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If you have any questions on the above response to the Draft Report, please contact Michael P. Barry at 703-962-3805.

Very truly yours,

*Arthur Andersen LLP*

Copies to:  
Roberta L. Gross, Inspector General of NASA  
Stephen J. Varholý, Acting Chief Financial Officer of NASA

See comment 11.

See comment 14.

See comment 15.

Appendix III: Comments From Arthur  
Andersen LLP and NASA's Inspector General

Note: GAO comments  
supplementing those in the  
report text appear at the  
end of this appendix.

National Aeronautics and  
Space Administration  
**Headquarters**  
Washington, DC 20546-0001



Reply to Attn of: Office of Inspector General

March 15, 2001

Mr. Gregory D. Kutz  
Director, Financial Management and Assurance  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Kutz:

We appreciate the opportunity to comment on the draft report on a misstatement that occurred in NASA's fiscal year (FY) 1999 Statement of Budgetary Resources.<sup>1</sup> NASA readily acknowledged that an error<sup>2</sup> had occurred primarily due to a misinterpretation of guidance for preparing the Statement of Budgetary Resources. During the audit of NASA's FY 1999 financial statements, Arthur Andersen did not identify the error that resulted in the misstatement. Our oversight of the financial statement audit process did not detect the misstatement or underlying error and found that Arthur Andersen had met applicable auditing standards. The error was fully disclosed and corrected as part of the FY 2000 financial statement preparation and audit process. The misstatement in NASA's Statement of Budgetary Resources did not materially affect either Total Outlays reported on the Statement or the President's Budget.

Arthur Andersen was required to perform an audit in accordance with Government Auditing Standards (GAS) that incorporated by reference the American Institute of Certified Public Accountants U.S. Auditing Standards (AU). The NASA Office of Inspector General (OIG) also had responsibilities for the FY 1999 financial statement audit as described in Office of Management and Budget (OMB) Bulletin 98-08, "Audit Requirements for Federal Financial

<sup>1</sup> The Statement of Budgetary Resources and the related disclosures provide information about how budgetary resources were made available as well as their status at the end of the period. This statement should be prepared by reporting entities whose financing comes wholly or partially from budgetary resources. Recognition and measurement of budgetary information reported on this statement should be based on budget terminology, definitions, and guidance in Office of Management and Budget Circular A-34, "Instructions on Budget Execution," dated December 26, 1995.

<sup>2</sup> The misstatement occurred in the Recoveries of Prior-Year Obligations line item in the Budgetary Resources section of the statement as a result of erroneously including prior year outlay amounts contrary to Office of Management and Budget guidance.

See comment 14.

See comment 16.

Statements," dated August 24, 1998.<sup>3</sup> The FY 1999 audit was the fourth year of a 5-year contract with Arthur Andersen to perform the NASA financial statement audit. During this 4-year period, major new guidance was issued related to the form and content of agency financial statements, adding new financial statements and other required disclosures<sup>4</sup> that are subject to audit examination starting in FY 1998 including the Statement of Budgetary Resources. To fulfill our responsibilities related to the FY 1999 audit, we performed a continuing quality control review over a 9-month period that resulted in numerous improvements to the financial statement preparation and audit process. During this period, we also worked to develop guidance for the quality control review process that would be useful on a Government-wide basis.<sup>5</sup> Our quality control review included:

- reviewing Arthur Andersen's audit planning and execution;
- monitoring audit progress including attending meetings such as entrance and exit conferences;
- examining audit working papers and reports;
- facilitating communication between policymakers, the General Accounting Office (GAO), NASA management, and Arthur Andersen; and
- assessing the follow-up activities on prior audit recommendations.

See comment 16.

With regard to the FY 1999 audit, we raised a variety of issues concerning audit tests and procedures related to such key items as property, information technology security, audit follow-up activities, expectations concerning examination of compliance with laws and regulations, and other matters that were resolved during our quality control review. The Department of Commerce OIG examined our quality control review process for the FY 1999 financial statement audit during our most recent external peer review with no exceptions noted.<sup>6</sup> We also made the working papers for this quality control review available for GAO examination at the time the FY 1999 audit was completed; again with no exception taken by GAO to our approach to fulfilling our oversight responsibilities.<sup>7</sup> In addition, GAO participated in meetings together with and

See comment 1.

<sup>3</sup> OMB Bulletin 98-08 states Inspectors General shall: (1) Ensure that audits are performed and audit reports are completed in a timely manner and in accordance with applicable requirements. This responsibility pertains to audits conducted directly by OIG staff and audits conducted by independent auditors under contract; (2) provide technical advice and liaison to agency officials and independent external auditors; (3) obtain or make quality control reviews of audits made by independent external auditors and provide the results, when appropriate, to other interested organizations; and (4) monitor and report on management's progress in resolving financial statement audit findings in accordance with the Inspector General Act of 1978, as amended; the provisions of OMB Circular A-50, "Audit Followup"; and other requirements.

<sup>4</sup> OMB Memorandum 99-03, Technical Amendments to OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," dated November 20, 1998, implemented Statements of Federal Financial Accounting Standards (SFFAS) No. 6, "Accounting for Property, Plant, and Equipment"; SFFAS No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting"; and SFFAS No. 8, "Supplementary Stewardship Reporting," all for fiscal years beginning after September 30, 1997.

<sup>5</sup> The NASA OIG participated in a working group established by the Federal Audit Executive Council to develop standard guidance for performing quality control reviews of financial statement audits of Federal entities. The resulting guidance, supplemented by additional procedures we considered necessary, was used by the NASA OIG in fulfilling its oversight responsibilities related to the FY 1999 financial statement audit by Arthur Andersen.

<sup>6</sup> Department of Commerce Inspector General, Peer Review of the NASA Office of Inspector General - Final Report, dated January 10, 2001.

<sup>7</sup> We agreed with GAO on an issue it raised at the time that the follow-on contract for financial statement audit services related to the FY 2001 and later financial statements should include additional emphasis on information technology security controls.

See comment 1.

separately from the NASA OIG on the financial statement audit, including the exit conference with representatives of the Chief Financial Officer and Arthur Andersen prior to issuance of the FY 1999 audit reports.

See comment 1.

GAO reported NASA's recognition that the error was primarily due to a misinterpretation of applicable guidance in preparing the Recoveries of Prior-Year Obligations line item<sup>8</sup> in the Statement of Budgetary Resources. The misstatement was not the result of underlying errors in the Agency's accounting records, and the misinterpretation is not indicative of overall problems with NASA's internal control.<sup>9</sup> Also, as previously stated, the misstatement did not materially affect the bottom line of the statement (Total Outlays).<sup>10</sup> The misstatement and surrounding circumstances certainly do not imply noncompliance with the Federal Financial Management Improvement Act (FFMIA) of 1996<sup>11</sup> as implemented by the OMB.<sup>12</sup> Rather, in our opinion, it constitutes an error related to reporting in the Statement of Budgetary Resources that has been addressed in the FY 2000 audit in accordance with auditing standards governing correction of errors. This conclusion more appropriately follows the facts: a relatively new financial statement; recognized difficulty by Federal agencies in its preparation;<sup>13</sup> subsequent understanding of the exact nature of the misinterpretation and its effect on the financial statements; and prompt corrective action by NASA management.

See comment 14.

Arthur Andersen did not identify the Recoveries of Prior-Year Obligations line item as a high-risk account in FY 1999 based on its audits of NASA's financial statements during the prior 3

See comment 6.

<sup>8</sup> OMB Circular A-34 indicates this line is used to report on unexpired and expired accounts and expired accounts being closed. The Circular states that the line includes the: "Amount of any cancellations or downward adjustments of obligations incurred in *prior fiscal years* that were *not outlayed*."

<sup>9</sup> AU 319.16 states: "Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entities control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of such human failures as simple error or mistake."

<sup>10</sup> The Recoveries of Prior-Year Obligations line item is not used to determine Total Outlays in the Statement of Budgetary Resources financial statement presentation.

<sup>11</sup> The 1997 Omnibus Consolidated Appropriations Act includes Title VIII, the Federal Financial Management Improvement Act of 1996. Section 803(a) of this Act states: "In General -- Each agency shall implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger (SGL) at the transaction level."

<sup>12</sup> OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, discusses substantial compliance with FFMIA and types of indicators to be used in assessing whether an agency is in substantial compliance. It states the criteria are broad and flexible; yet, they provide a practical basis for measuring achievement in complying with the FFMIA requirements. The Bulletin emphasizes that judgment shall be used in determining a lack of substantial compliance with an indicator.

<sup>13</sup> Federal Accounting and Reporting: Framework for Assessing the Reliability of Budget Execution Data is Not Yet Fully Implemented, GAO-01-43, October 6, 2000. The GAO reported that the Statement of Budgetary Resources is a relatively new financial statement first required by OMB as of September 30, 1998, and that Federal agencies encountered difficulty in preparing the statement. The major problems GAO identified included (1) data quality problems, which affected the agencies' overall financial statements and precluded any auditors' determination of the reliability of the amounts presented, and (2) lack of disclosure of significant differences between the Statement of Budgetary Resources and the Program and Financing Schedules of the President's Budget. Contributing to the second problem was a lack of recognition by some agencies of differences in reporting requirements for budget execution data in the Statement of Budgetary Resources and the President's Budget. Also, it should be noted that OMB is currently considering revisions to its guidance on the Statement of Budgetary Resources, at least in part, due to difficulties reported by GAO in the preparation of this statement.

See comment 17.

years. Such risk-based judgments are a routine part of the audit process, and the conclusion is supported when viewed from the perspective that the audit opinion is expressed on the financial statements, taken as a whole.<sup>14</sup> The audit was not singularly focused on the Recoveries of Prior-Year Obligations line item or the Statement of Budgetary Resources, but rather on a set of financial statements, including other required disclosures. Further, auditing standards do not require opinions on internal control or compliance with laws and regulations as part of a financial statement audit.<sup>15</sup>

See comment 18.

Nonetheless, the analytical review procedures performed by Arthur Andersen detected the variance in the FY 1999 Statement of Budgetary Resources compared to FY 1998, and the auditors inquired to their satisfaction about the reasons for the variances. Unfortunately, in retrospect, those inquiries did not go far enough. Transaction testing, however, would likely not have aided in the detection of, or shed further light on, the nature of the variance. Arthur Andersen did not corroborate, through review of OMB Circular A-34 requirements, whether outlays from prior year appropriations should be included in the Recoveries of Prior-Year Obligations line item on the Statement of Budgetary Resources. The wording in the Circular can be interpreted in various ways; however, the fact remains that additional inquiry or corroboration could have disclosed the incorrect interpretation by NASA management. The error resulted in an overstatement of Total Budgetary Resources.

See comment 2.

This single error in auditor judgment does not, however, rise to the level of violating auditing standards. Exercising due professional care requires auditors to make judgments about the extent of work to perform based on their knowledge about the organization and the results of prior work. Due professional care during the performance of an audit neither implies infallibility on the part of the auditor or audit organization<sup>16</sup> nor guarantees that material misstatements will be detected.<sup>17</sup> With hindsight, it is easy to speculate about additional steps that Arthur Andersen could have taken that may have detected the misstatement. However, the simple fact is that Arthur Andersen did not take these steps, even though the firm's work met applicable auditing

<sup>14</sup> AU 504.01, the fourth standard of reporting.

<sup>15</sup> In its report on internal control for FY 1999, Arthur Andersen stated: "With respect to internal control over financial reporting, we obtained an understanding of the design of relevant policies and procedures and whether they had been placed in operation, and we assessed control risk and performed tests of controls in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control over financial reporting. Accordingly, we do not express such an opinion on the internal control over financial reporting." Similar wording appears in the report on compliance with laws and regulations, stating that no opinion is expressed.

<sup>16</sup> Government Auditing Standards (GAS) 3.30, concerning due professional care states: "While this standard places responsibility on each auditor and audit organization to exercise due professional care in the performance of an audit assignment, it does not imply unlimited responsibility; neither does it imply infallibility on the part of either the individual auditor or the audit organization."

<sup>17</sup> AU 230.10 states: "The exercise of due professional care allows the auditor to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by fraud or error. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement." AU 230.13 states: "Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material statement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with generally accepted auditing standards."

See comment 14.

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standards.<sup>18</sup> Arthur Andersen's response to the identification of the misstatement, consistent with applicable standards,<sup>19</sup> was to make disclosure in its FY 2000 audit report and reconsider assessments of audit risk that resulted in significantly increased audit work on the Statement of Budgetary Resources in FY 2000.

Our oversight of the work performed by Arthur Andersen did not detect the error or resulting misstatement or identify the Recoveries of Prior-Year Obligations line item as a high-risk account that would have required Arthur Andersen to perform additional audit procedures. However, the quality control review we performed is not a substitute for the audit.<sup>20</sup> GAO also provided oversight of the NASA financial statement audits as part of its responsibilities as the principal auditor for the U.S. Government-wide financial statements.<sup>21</sup> In this capacity, GAO participated annually in various meetings at NASA concerning the financial statement audits and reviewed Arthur Andersen's working papers<sup>22</sup> and those supporting the quality control review by the NASA OIG. GAO is not expected to re-audit agency financial statements to fulfill its role as principal auditor for the U.S. Government financial statements. Similarly, although the NASA OIG exercised due professional care, we did not re-audit the statements. Applicable standards are clear that an audit does not provide absolute assurance that financial statements are free of material misstatement, and our oversight should not be held to an implied infallibility standard.

Nevertheless, we have taken steps to strengthen our oversight of NASA's financial statement audits. For example, we advised GAO that, starting with FY 2001, our principal auditor will be required by contract to use the GAO Financial Audit Manual (FAM) once finalized,<sup>23</sup> and our quality control process will be modified accordingly. Therefore, we concur with the GAO recommendation to incorporate requirements of the forthcoming revision to the FAM in our

<sup>18</sup> AU Section 329 addresses the use of analytical procedures. It calls for the auditors to obtain sufficient evidence to satisfy themselves as to whether there is a likely misstatement and emphasizes the exercise of auditor judgment in this regard. As discussed in Footnote No. 17, however, there is no expectation of absolute assurance.

<sup>19</sup> Concerning the materiality of the misstatement, AU 420.10 recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. As a result of consideration of these factors, the NASA OIG has concluded the error was material for purposes of disclosure in the FY 2000 financial statements and related audit reports.

<sup>20</sup> The Inspector General stated in a February 17, 2000, letter accompanying the Arthur Andersen audit reports in NASA's FY 1999 accountability report: "Our review, as differentiated from an audit in accordance with generally accepted government auditing standards, was not intended to express, and we do not express, opinions on NASA's financial statements or on conclusions about the effectiveness of internal control or compliance with laws and regulations. Arthur Andersen is responsible for the attached auditor's report and for the conclusions expressed in the report. However, our review showed that Arthur Andersen complied, in all material respects, with applicable standards and mandated requirements."

<sup>21</sup> The Comptroller General of the United States, in the GAO report dated March 20, 2000, on the Federal Government-wide financial statements, stated: "At CFO (Chief Financial Officers) Act agencies and other agencies, we reviewed the fiscal year 1999 financial statement audits performed by the IGs (Inspectors General) or their contractors and, for certain agencies, assisted in the development of audit plans for fiscal year 1999 audits." As the principal auditor, the GAO disclaimed an opinion on the Federal Government-wide financial statements for FY 1999.

<sup>22</sup> Statements on Auditing Standards 543.10-12 discuss procedures to be used by the principal auditor to obtain satisfaction with regard to the work of other auditors. These procedures can include a review of working papers and related inquiries of the other auditors.

<sup>23</sup> The NASA OIG has participated in the joint effort by the President's Council on Integrity and Efficiency and GAO to update the FAM so that it will become accepted on a Government-wide basis for Federal financial statement audits.

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quality control process for future audits. It is important to note, however, that the FAM is not required by applicable auditing standards and was not a part of the prior contract for these audit services.

The Enclosure lists the key issues raised in your draft report and provides our views on each of those issues. We understand that NASA management and Arthur Andersen will be responding separately to the draft report. We believe it would be beneficial to meet after you have reviewed these responses. Should you have any questions or need additional information, please call me on (202) 358-1232.

Sincerely,

A handwritten signature in black ink, appearing to read 'Russell A. Rau', with a stylized flourish at the end.

Russell A. Rau  
Assistant Inspector General  
for Auditing

Enclosure

**NASA Office of Inspector General (OIG)  
Response to Findings and Recommendations in  
Draft GAO Report: FINANCIAL MANAGEMENT  
Misstatement of NASA's Statement of Budgetary Resources  
GAO-01-438, Dated February 2001**

**Background:**

The following narrative lists each of the issues raised in the GAO report and provides our analysis and position on those issues.

**GAO Issue:** NASA used an ad hoc process to gather and submit data not captured by NASA's general ledger system and mistakenly added disbursements from expired appropriations accounts to the Recoveries of Prior-Year Obligations line item on the Statement of Budgetary Resources. NASA did not attempt to reconcile the significant difference between the recoveries as reported on the Statement of Budgetary Resources and as reported on the President's Budget Program and Financing (P&F) schedules.

**NASA OIG Response:** We agree with the GAO description but have several comments. First, the fact that an ad hoc process was used does not imply that there are deficiencies in internal control or that NASA does not substantially comply with the Federal Financial Management Improvement Act (FFMIA), especially in a situation where the resulting information is not material to the financial statement. The absence of an integrated, transaction-driven general ledger system at NASA and other Federal agencies at times requires the use of such processes, and the extent of validation required should be commensurate with the materiality of the line item to the overall financial statement. The process NASA used to gather the information reported on the Recoveries of Prior-Year Obligations line item in FY 1999 could reasonably be referred to as an ad hoc process because it was the first time NASA had gathered that information, and the process had not been tested. However, the term ad hoc is no longer applicable. Because of the error in FY 1999, NASA has taken action to strengthen and refine its process. These actions included implementing an independent verification and validation process to ensure accuracy of data inputs and compliance with standard general ledger procedures and issuing revised guidance to aid its Centers in accurately compiling recoveries of prior year obligations information. In addition, NASA created and plans to maintain a contract modifications file to support the amounts reported as Recoveries of Prior-Year Obligations. During its FY 2000 audit, Arthur Andersen tested a sample of these contract modifications to confirm the accuracy of the restated FY's 1999 and 2000 Recoveries of Prior-Year Obligations information reported in the NASA FY 2000 Accountability Report. Second, we understand that NASA did reconcile the P&F Schedules in the President's Budget to the SF 133, "Report on Budget Execution," which was the basis for the Statement of Budgetary Resources. This reconciliation did not identify the misstatement, because NASA understood that there were differences in reporting requirements. It should also be noted that the vast majority of the error in NASA's Statement of Budgetary Resources did not carry over to the President's Budget. The majority of the error was in figures reported for "expired accounts," and OMB guidance requires agencies to report information on "expired accounts" differently in the Statement of Budgetary Resources and the President's Budget. A relatively small portion (\$29 million) of the error was

See comment 1.



due to incorrect interpretations of downward adjustments, and these adjustment errors were reflected in the President's budget. Overall, this is not the primary cause or a material part of the misstatement.

**GAO Issue:** Evidence in Arthur Andersen's working papers was not adequate to support unqualified audit opinions on NASA's Statement of Budgetary Resources and Statement of Financing in accordance with GAS.

See comment 1.

**NASA OIG Response:** Arthur Andersen's opinion was not rendered on the individual statements. Obtaining and evaluating evidence<sup>24</sup> are key parts of every audit and are guided, in part, by risk assessment. Applicable standards call for the auditor to obtain an understanding of internal control to identify the types and risk of potential misstatements and to design substantive tests accordingly. Arthur Andersen complied with these requirements, as documented in the related working papers. GAO points to additional risks but provides no basis for its conclusion that additional audit work was required in these areas. In an entity the size of NASA, there are numerous risks, and each could be subjected to audit tests and procedures. However, such an audit would be unaffordable in both time and resources. The GAO report should recognize that financial statement audits are an iterative process that builds upon Arthur Andersen's prior experience with NASA as well as work performed in the FY 1999 audit. When planning audit work for the current year, Arthur Andersen properly considered the results of prior year audits and knowledge about NASA and its internal control.<sup>25</sup> Arthur Andersen determined that the risk of a material misstatement on the Statement of Budgetary Resources was low based on the firm's examination of NASA's internal control in FY's 1996 through 1998 and planned FY 1999 audit work accordingly. The GAO did not fully consider the audit work related to internal control performed by Arthur Andersen in prior audits.

A key question to be considered is whether Arthur Andersen exercised due professional care in conducting the FY 1999 audit of NASA's financial statements given that the misstatement occurred. We believe the answer to that question is yes. Concerning due professional care, GAS 3.30 states, "While this standard places responsibility on each auditor and audit organization to exercise due professional care in the performance of an audit assignment, it does not imply unlimited responsibility; neither does it imply infallibility on the part of either the individual auditor or the audit organization."

Regarding the obligation for due professional care, AU 230.03 states, "But no man, whether skilled or unskilled, undertakes that a task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment."

The guidance shows that the exercising of due professional care allows an auditor to obtain reasonable assurance that the financial statements are free of material misstatement, whether

<sup>24</sup> AU 230.11 and AU 326.22 state, "Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole are fairly presented are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being audited."

<sup>25</sup> AU 319.23 states that in obtaining an understanding of internal control, sources include previous audits and the understanding of the industry in which the entity operates.

caused by fraud or error. Since absolute assurance is not attainable, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement. This concept is explained in AU 230.13, which states:

Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with generally accepted auditing standards.

**GAO Issue:** Arthur Andersen's working papers did not adequately document the evaluation of the internal controls related to the two budgetary statements or the independent validation of key amounts in the statements for fiscal year 1999. Specifically, GAO stated:

In our review of the auditors' working papers for the NASA fiscal year 1999 audit, we did not see evidence of a sufficient understanding of the internal control process relative to budgetary execution to support the extent of reliance Arthur Andersen placed on internal controls.

We found limited evidence of any testing of internal controls or underlying data relating to key balances on the budgetary statements. Instead, Arthur Andersen relied on analytical procedures to support key budgetary balances, such as recoveries and \$2.2 billion of undelivered orders. Moreover, Arthur Andersen's analytical procedures did not meet the requirements of SAS 56. [SAS 56, Analytical Procedures, provides guidance on the use of analytical procedures.]

See comment 2 and 6.

**NASA OIG Response:** We disagree with the GAO conclusion. The draft GAO report focuses considerable attention on evidence in the Arthur Andersen working papers related to the auditors' understanding of internal control but does not acknowledge that applicable auditing standards provide considerable flexibility in these areas as to the nature and extent of such documentation. Regarding Arthur Andersen's understanding of NASA's internal control process, the auditors performed sufficient work to comply with auditing standards. GAS 4.32, states that auditors can use evidence from tests of controls done in prior audits when assessing control risk and that is exactly what Arthur Andersen did. Arthur Andersen relied on a body of audit work performed for FY's 1996 through 1998 to support its conclusion that NASA had adequate high-level processes and controls in place for the budget cycle, which precluded the need for detailed testing of the controls in FY 1999. Arthur Andersen's FY 1996 work included transaction testing of selected general ledger budgetary accounts at Headquarters, Goddard Space Flight Center, Johnson Space Center, Kennedy Space Center, and Marshall Space Flight Center. Having found no significant problems the previous year, in FY 1997, Arthur Andersen selected two appropriations and traced the data from NASA's adjusted trial balance to the SF 133, "Report on Budget Execution," submission to the Treasury. Based on that work, Arthur Andersen concluded that NASA's control process over the preparation of the SF 133 is effective to prevent the occurrence of material misstatements. In FY 1998, Arthur Andersen performed limited testing of NASA Resources Authority Warrants (NF 506), which are the official documents NASA uses to allocate resources authority for appropriated funds, and Allotment Authorizations (NF 504), which are the official documents for allotting funds to finance Agency-approved programs, projects, and other activities. Arthur Andersen determined that the warrants and allotments were

properly approved and conformed to NASA's Operating Plan for budget execution. Arthur Andersen also reviewed selected budget reconciliation reports prepared by NASA and noted no exceptions.

See comment 1.

Regarding Arthur Andersen's testing of internal controls and underlying data relating to key balances and the adequacy of its analytical procedures, several factors support the fact that the firm's work was sufficient to meet auditing standards. First, Arthur Andersen detected that NASA was not reporting Recoveries of Prior-Year Obligations the very first year the Agency was required to prepare a Statement of Budgetary Resources. During the FY 1998 audit, Arthur Andersen properly noted that NASA had not previously reported Recoveries of Prior-Year Obligations and orally advised<sup>26</sup> the Agency to report the recoveries in the FY 1998 Statement of Budgetary Resources. NASA advised Arthur Andersen that NASA could not report Recoveries of Prior-Year Obligations in FY 1998 because the Agency needed to develop a new procedure to obtain the information from its Centers, and not enough time remained before the FY 1998 statements were to be published. NASA committed to having a new procedure in place in time to report Recoveries of Prior-Year Obligations in the FY 1999 Statement of Budgetary Resources.

See comment 6.

See comment 2.

Second, Arthur Andersen determined that the firm could test the budget cycle in alternating years because the prior 3 years' work did not identify any significant deficiencies in NASA's internal control over the budget process. This was a reasonable audit decision. In 1999, Arthur Andersen limited its audit work on the Statement of Budgetary Resources to evaluating the NASA financial report preparation process and performing analytical procedures<sup>27</sup> including (1) comparing the information presented in the Statement of Budgetary Resources to that reported on NASA's SF 133,<sup>28</sup> and (2) comparing certain key figures on the statement to other sources such as appropriation laws and Treasury balances to verify the reasonableness of the figures presented in the Statement of Budgetary Resources. These procedures detected the variance in the line item, Recoveries of Prior-Year Obligations, and Arthur Andersen made inquiries concerning the appropriateness of the balance reported. AU 329.21, requires that "(t)he auditor should evaluate significant unexpected differences." In this case Arthur Andersen did evaluate the difference.

See comment 1.

Arthur Andersen accepted the methodology NASA used to compute the Recoveries of Prior-Year Obligations line item based on the research of the guidance performed by the NASA Chief Financial Officer, which included discussions with OMB. Arthur Andersen placed too much reliance on NASA's interpretation of the components of the Recoveries of Prior-Year Obligations line item but did, in fact, evaluate the difference. As a result, Arthur Andersen did not review the backup documentation or recalculate the Recoveries of Prior-Year Obligations or other line items on the Statement of Budgetary Resources to ensure that NASA had fully complied with OMB Circular A-34. However, this single error in judgment does not necessarily lead to a conclusion that the audit as a whole was not performed in accordance with standards.<sup>29</sup> Arthur Andersen compared the Statement of Budgetary Resources to the SF 133 and concluded

See comment 2.

<sup>26</sup> In retrospect, the lack of reporting of Recoveries of Prior-Year Obligations could have been included in the management letter accompanying the FY 1998 audit reports. This "best practice" would have focused additional attention on this line item during the FY 1999 audit.

<sup>27</sup> Analytical procedures use comparisons and relationships to determine whether account balances appear reasonable.

<sup>28</sup> The SF 133 report is the basis for preparation of the Statement of Budgetary Resources.

<sup>29</sup> See Footnote No. 17.

that NASA had reported its budget information consistently on both documents. The comparison did not identify the misstatement in Recoveries of Prior-Year Obligations because NASA used the same manual process to calculate and enter the data in both documents.

See comment 2.

In addition, the GAO report implies that Arthur Andersen did not perform sufficient audit work to support key balances on budgetary statements and specifically cites NASA's \$2.2 billion of undelivered orders. Undelivered orders are not reported as a distinct line item on the Statement of Budgetary Resources. Rather, undelivered orders are included on the statement as part of other line items such as obligations incurred. Arthur Andersen performed sufficient work to obtain reasonable assurance that NASA's reporting of its appropriations including undelivered orders was not materially misstated. At the end of the fiscal year, Agency appropriations are either expended or unexpended. Expended appropriations relate to amounts recorded as expenses and reported on the Statement of Net Cost. Each year, a significant portion of Arthur Andersen's work is devoted to ensuring that NASA properly records and reports expenses. Unexpended appropriations include undelivered orders and unobligated balances. Arthur Andersen performed a variety of audit tests to ensure that NASA properly accounted for its unexpended appropriations. For example, Arthur Andersen analyzed NASA's disbursements testing to ensure the completeness and accuracy of amounts accrued in the accounting records and reperformed the testing on a sample of transactions. Because it identified no exceptions, Arthur Andersen concluded that the total population of expended appropriations as opposed to unexpended appropriations was not materially misstated. Arthur Andersen verified unobligated balances disclosed in the footnotes to the financial statements to the disclosure of Funds Held with Treasury and to NASA reports submitted to Treasury, which the Agency generated from its general ledger. Arthur Andersen tested NASA's reconciliations of its general ledger information to Treasury statements during its testing of controls. Finally, because Arthur Andersen's testing of obligations in prior years had not identified any weakness in NASA's controls, the firm did not test obligations in FY 1999. While Arthur Andersen did not specifically target and test undelivered orders, its work on total appropriations, expended appropriations, and unobligated balances was sufficient to conclude that undelivered orders were not materially misstated.

See comment 17.

Finally, OMB Bulletin 98-08, "Audit Requirements for Federal Financial Statements," and generally accepted government auditing standards do not require an audit opinion on internal controls or compliance with laws and regulations. In its FY 1999 Report of Independent Public Accountants on Internal Control, Arthur Andersen stated:

In planning and performing our audit of the financial statements of NASA for the year ended September 30, 1999, we obtained an understanding of NASA's internal control over financial reporting. With respect to the internal control over financial reporting, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk and performed tests of controls in order to determine our auditing procedures for purposes of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Accordingly, we do not express such an opinion on the internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions.<sup>30</sup>

<sup>30</sup> Reportable conditions are matters coming to the auditor's attention relating to significant deficiencies in the design or operation of internal control that, in the auditor's judgment, could adversely affect NASA's ability to record, process, summarize, and report financial data consistent with the assertions in the financial statements.

Although Arthur Andersen did not opine on NASA's internal controls, there was no requirement to perform testing to a level to render such an opinion.

**GAO Issue:** The deficiencies in NASA's general ledger and the error in NASA's Statement of Budgetary Resources described earlier raise questions about Arthur Andersen's conclusion that NASA's systems complied substantially with the requirements of the FFMA. We found inadequate evidence in Arthur Andersen's working papers to support its conclusion on NASA's FFMA compliance. Specifically, GAO stated:

The systems deficiencies that led to the Statement of Budgetary Resources error and Arthur Andersen's lack of understanding of the ad hoc process used by NASA to work around these deficiencies also raise questions about Arthur Andersen's conclusions that NASA's systems comply substantially with FFMA.

See comment 1.

**NASA OIG Response:** We disagree with the GAO conclusion. The FFMA requires Federal agencies to "implement and maintain financial management systems that comply substantially with Federal financial management systems requirements [that is, OMB Circular A-127<sup>31</sup>], applicable Federal accounting standards, and the United States Standard General Ledger at the transaction level." Further, the Act requires the Head of each agency to determine whether the financial management systems of the agency are in compliance with the provisions of the Act. If the agency is not in compliance, the Head of the agency, in cooperation with OMB, must establish a remedial plan to bring the agency's financial management systems into compliance. As an aid to agencies and auditors in assessing compliance with the Act, OMB published preliminary guidance in September 1997 and updated and refined this guidance in Attachment D of OMB Bulletin 98-08. For each of the required compliance areas, OMB's guidance provides information on substantial compliance and indicators to be used in assessing whether an agency is in substantial compliance.

In FY 1999, as was done in the prior 2 years, NASA assessed its compliance using the OMB indicators and determined that it was in substantial compliance. Arthur Andersen reviewed NASA's assertion of compliance and concluded that NASA was in substantial compliance with FFMA based on discussions with NASA management, Electronic Data Processing testing, the firm's knowledge of the Agency's financial systems gained over several years, testing of NASA's financial reporting process, the thousands of hours of audit work the firm performed to render opinions on NASA's financial statements, and discussions with OMB officials.

GAO's first point was that the misstatement itself would indicate noncompliance with FFMA. We do not believe that a misstatement in one line item on one financial statement would in itself tip the balance from substantial compliance with FFMA to noncompliance. As previously discussed, the misstatement was primarily due to a misunderstanding of what information NASA should include in the Recoveries of Prior-Year Obligations line item and secondarily to shortcomings in the guidance NASA Headquarters sent to its Centers for extracting the information. NASA now understands the proper composition of the Recoveries of Prior-Year Obligations line item and has corrected the guidance provided to the Centers. The other two

<sup>31</sup> OMB Circular A-127, "Financial Management Systems," prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.

See comment 1.

areas where questions could be raised concerning NASA's compliance with FFMIA are the fact that the Agency does not use the U.S. Standard General Ledger (USSGL) to capture financial information and the Agency's lack of a single, integrated financial management system.

See comment 13.

The OMB indicator for compliance with use of the USSGL at the transaction level allows for an agency to use an alternative code (pseudo-code) following the same account descriptions and posting rules that are used by the USSGL to capture financial information. The use of the USSGL code in the feeder systems is not necessary as long as the code definitions used to capture information are consistent with the USSGL definitions. NASA uses pseudo-codes that substantially comply with the USSGL account descriptions and posting rules. A crosswalk<sup>32</sup> to the USSGL accounts provides the balances that are necessary for reporting to OMB or the Treasury and for preparing the financial statements. In 1996, Arthur Andersen reviewed and tested NASA's crosswalk to ensure that it complied with Treasury guidance and was accurately prepared. Each year thereafter, Arthur Andersen reviewed and tested the accounts NASA added to the crosswalk to ensure that the new accounts complied with Treasury guidance. Arthur Andersen's practice of reviewing new accounts is reasonable because the other accounts had already been determined to comply with Treasury guidance. When asked by Arthur Andersen, OMB also confirmed that an agency would be considered to be in substantial compliance with the USSGL requirements if the agency can crosswalk its accounts to the USSGL. NASA meets these criteria; therefore, there is no basis for a noncompliance determination.

OMB Circular A-127 requires agencies to maintain a single, integrated financial management system. While NASA's financial management systems are not integrated and not efficient, NASA has implemented compensating procedures that provide reasonable assurance regarding the fundamental completeness and integrity of NASA's internal accounting and administrative controls related to its financial systems. Therefore, NASA's system nonconformance is not a basis for a noncompliance determination. When asked by Arthur Andersen, OMB confirmed that the nonconformance under OMB Circular A-127 is not sufficient to trigger noncompliance with FFMIA.

**GAO Issue:** The revised Statement of Budgetary Resources amounts submitted to the Chairman, Committee on Science, U.S. House of Representatives, on September 21, 2000, were not subject to independent audit. However, NASA OIG officials told us that they asked Arthur Andersen to verify the revised fiscal year 1999 Statement of Budgetary Resources amounts as part of its fiscal year 2000 audit, which was not complete at the time of our review.

**NASA OIG Response:** GAO is correct that NASA's response to the Congress was not audited. Also, at the time GAO performed its field work, the FY 2000 financial statement audit was not complete. NASA's FY 2000 financial statements include corrected data for the FY 1999 Statement of Budgetary Resources, and the error and revision are explained in a footnote to the financial statements. Arthur Andersen has since completed its audit and issued an unqualified opinion of NASA's FY 2000 financial statements including the corrected FY 1999 Statement of Budgetary Resources. The audit report appropriately references the footnote disclosure of the revision to the statement. Because of the concerns raised by the FY 1999 error, Arthur Andersen substantially expanded its audit work related to the FY 2000 Statement of Budgetary Resources.

See comment 15.

<sup>32</sup> A "crosswalk" is used to move financial information from the line items in NASA's general ledger systems to the line items in the U.S. Government Standard General Ledger or other line item structure.

See comment 14.

See comment 1.

See comment 14.

Arthur Andersen's work included steps to verify the overall accuracy of the Statement of Budgetary Resources format and content and to ensure that budget information was accurately reported to the Treasury and in the President's Budget. To test the validity of the budgetary information received from the Centers, Arthur Andersen reviewed the reconciliations performed between the Center general ledgers and the Agencywide general ledger and ensured that all differences were resolved. Arthur Andersen also ensured that the Center's Deputy Chief Financial Officer certified all obligations incurred at each Center. To test the format of the Statement of Budgetary Resources, Arthur Andersen verified that the form and content NASA used for its Statement of Budgetary Resources conformed to the requirements of OMB Circular A-34 and verified that the description of accounts for each line item on NASA's Statement of Budgetary Resources crosswalk schedule were consistent with OMB standards. Arthur Andersen also verified that any information excluded from the Statement of Budgetary Resources by NASA was properly excluded. To test the accuracy of the information reported on the Statement of Budgetary Resources, Arthur Andersen traced the information on the spreadsheet that NASA uses to crosswalk its general ledger to the statement and to the SF 133 and found no problems. The firm also traced the separate appropriated fund totals on the spreadsheet to the SF 133, which confirmed that the Statement of Budgetary Resources agreed to the amounts reported to the Treasury. Finally, Arthur Andersen performed a reasonableness test that consisted of tracing selected accounts for each appropriation code to the Statement of Budgetary Resources, the SF 133, and the President's Budget which showed that the information was consistently reported.

In addition to its overall work to ensure the accuracy of the Statement of Budgetary Resources, Arthur Andersen performed specific work to ensure the accuracy of the Recoveries of Prior-Year Obligations line item for both FY's 1999 and 2000. For FY 1999, Arthur Andersen traced the balance reported by each of the Centers to the total reported on the restated Recoveries of Prior-Year Obligations line item. Arthur Andersen then selected the two Centers with the largest reported downward adjustments<sup>33</sup> and traced all the adjustments greater than \$500,000 back to the contract modifications and found no problems. For FY 2000, Arthur Andersen again traced the balance reported by each of the Centers to the total reported for the Agency. Because it found no problems during the FY 1999 test, for FY 2000, Arthur Andersen judgmentally selected three downward adjustments and traced them to the contract modifications and found no problems. Based on its work, Arthur Andersen concluded that NASA's process for capturing downward adjustments was in place and operating effectively.

**GAO Issue:** The NASA OIG reviewed Arthur Andersen's working papers and audit reports using a detailed checklist it developed based on GAS. The NASA Inspector General did not identify the error in the Statement of Budgetary Resources or question the extent of the audit procedures applied to the budgetary statements or to assess compliance with FFMIA.

**NASA OIG Response:** We did not identify the error or resulting misstatement or question the extent of Arthur Andersen's tests and procedures related to the Recoveries of Prior Year Obligations line item on the Statement of Budgetary Resources. As GAO acknowledged in its report, the NASA Inspector General letter transmitting Arthur Andersen's report to the NASA Administrator and Chief Financial Officer, which was included in the Fiscal Year 1999 Accountability Report, states that the Inspector General did not express opinions on NASA's financial statements or on conclusions about the effectiveness of internal controls and

<sup>33</sup> Recoveries of Prior-Year Obligations are adjustments to agency budgetary resources.

compliance with laws and regulations. The letter states that Arthur Andersen is responsible for the auditor's report and for the conclusions expressed in the report. As part of our monitoring, we make judgments about potential problem areas considering the work performed by the auditor during the current year and any previous related audit work and focus our attention on the areas that we judge to be the highest risk. Audit oversight is not expected to identify all problems or substitute for the audit itself, but oversight can help ensure overall compliance with auditing standards, which we believe was accomplished in FY 1999. Most especially, audit oversight applied over a period of years and combined with active outreach within the Federal audit community has enabled us to ensure critical areas such as property, information systems security, and obligations management receive appropriate audit attention.

Concerning our oversight of Arthur Andersen's audit work related to compliance with FFMIA, GAO indicates in its draft report that it did not see any testing in Arthur Andersen's working papers related to FFMIA. In fact, Arthur Andersen performed various tests of Electronic Data Processing controls to assess compliance with OMB Circular A-127 and actually performed retesting of general controls at one of the NASA Centers based on our oversight reviews in this area. We emphasized to Arthur Andersen the need to continue to highlight weaknesses in information security in its reports, which was done. Additionally, just as Arthur Andersen has considerable knowledge of NASA internal control through financial statement audits, we similarly have knowledge based on our program of performance and information systems audits against which we can assess NASA's assertions with regard to substantial compliance with FFMIA.

As discussed in our transmittal letter, our oversight of NASA's FY 1999 financial statement audit was performed with due professional care, and we invested considerable resources in oversight activities including direct participation by senior OIG audit management. However, we have reviewed and strengthened our quality control procedures for monitoring the work of independent public accountants. We will update our quality control review guidance to incorporate the GAO/President's Council on Integrity and Efficiency FAM requirements as soon as the manual is issued. In addition, as mentioned in GAO's report, we have included the requirement for the auditors to follow the FAM in the statement of work for our future audit services contract, which will be in effect for the audit of NASA's FY 2001 financial statements.



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The following are GAO's comments on the letters dated March 15, 2001, from Arthur Andersen LLP and the NASA IG.

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## GAO Comments

1. See the "Comments and Our Evaluation" section of this report.
2. We disagree with Arthur Andersen and the NASA IG that the audit of the fiscal year 1999 NASA financial statements met all professional standards. As discussed in the body of this report and the "Comments and Our Evaluation" section, Arthur Andersen's work did not meet professional standards in at least three key areas: (1) GAGAS fieldwork standards relating to a sufficient understanding of the internal control structure, (2) GAGAS fieldwork standards relating to sufficient competent evidential matter, and (3) SAS No. 56 requirements for analytical procedures.
3. We agree that the \$644 million SBR reporting error discussed in our report represented less than 5 percent of NASA's budgetary resources. However, the total fiscal year 1999 SBR errors as reported in the NASA fiscal year 2000 financial statements were nearly \$1.3 billion. The errors include not only the \$644 million on the Recoveries line, but also \$644 million on the Obligations Incurred line. As noted in our report, the fact that the House Committee on Science, a user of the financial statements, questioned whether the amounts in the SBR were correct, is an indicator that the error was material. In addition, the \$1.3 billion in errors is nearly 9 times greater than Arthur Andersen's audit materiality threshold of \$150 million.
4. As stated in our report, Arthur Andersen did not identify all material risks related to the SBR and Statement of Financing. For example, we found inappropriate risk assessments related to Recoveries and Undelivered Orders. In addition, as Arthur Andersen and the NASA IG noted, there is a great deal of confusion related to reporting and auditing of SBR information. This confusion further supports our conclusion that Arthur Andersen's low risk assessment related to the budgetary statements was inappropriate.
5. As discussed in the "Comments and Our Evaluation" section, we did consider work Arthur Andersen conducted in prior years' audits. Arthur Andersen provided us with what it represented to be all working papers from fiscal year 1996 through 1999 that supported its fiscal year 1999 opinions on the SBR and Statement of Financing. Our

conclusion that Arthur Andersen's work was not adequate was based on our review of the fiscal year 1996 through 1999 working papers.

6. We agree that the use of prior-year testing of controls is acceptable under the conditions stated in GAGAS. However, Arthur Andersen's fiscal year 1996 through 1998 control work was not sufficient to provide any reliance relating to key budgetary accounts, such as Recoveries and Undelivered Orders. For example, because NASA's new ad hoc process relating to Recoveries was a significant change in NASA procedures, Arthur Andersen's reliance on its prior audits was inappropriate and inconsistent with the conditions in GAGAS.
7. We disagree that the error was fully offset in the SBR. The SBR presents three separate but related sections—Budgetary Resources, Status of Budgetary Resources, and Outlays. As discussed in the Background section of our report, each section has special meaning. The \$1.3 billion of errors in the fiscal year 1999 SBR resulted in misstatements in both Total Budgetary Resources and Total Status of Budgetary Resources. Because the errors net out in the Outlays section, they have no impact on Total Outlays. We agree with Arthur Andersen that the SBR misstatements had no effect on the Statement of Financing.
8. We agree with Arthur Andersen that the reporting error did not impact the Statement of Financial Position, Statement of Net Cost, and Statement of Changes in Net Position. However, we disagree that these three financial statements are the "key" financial statements. The SBR and Statement of Financing are at least as important as the other three financial statements and are required principal financial statements because of the importance of budgetary reporting in the federal government. Information on the status and use of budgetary resources is critical to agency management and the Congress.
9. We disagree with Arthur Andersen's statement that federal agencies' ability to use Recoveries is far more complex than the draft report suggests. Our report clearly states that certain recoveries of prior-year obligations result in budgetary resources that are available for new obligations, while others are available only for upward adjustments of valid prior-year obligations.
10. Arthur Andersen states that other agencies received clean opinions that were ultimately determined to contain reporting errors. We disagree with Arthur Andersen's characterization of the findings in our

earlier report. Our report found significant differences between amounts in the other agencies' SBR and the P&F Schedules that were not properly disclosed in notes to the financial statements as required. However, unlike the fiscal year 1999 NASA SBR errors, the differences we noted in our earlier study were not errors in the SBR. The issue is whether Arthur Andersen performed an adequate audit regarding the SBR that would have reasonably disclosed such an error on a principal financial statement.

11. We disagree with Arthur Andersen that it is undisputed that the reporting error in NASA's 1999 SBR was due to NASA financial management's misunderstanding of the precise components of the Recoveries line item. While management's misunderstanding certainly was a contributing factor, a fundamental reason for the misstatement was an inadequacy in NASA's management system. Specifically, the ad hoc process that resulted in the misinterpretation and error would not have been necessary if NASA had the required SGL accounts to appropriately accumulate the required information during fiscal year 1999 in accordance with generally accepted accounting principles.
12. A fundamental reason for the errors relates to systems deficiencies at NASA. We found no evidence of a deliberate attempt by NASA to gain advantage as a result of these errors.
13. Arthur Andersen and the NASA IG make numerous references to crosswalks to the SGL accounts as evidence that NASA's systems comply with FFMIA. OMB does allow for alternative codes as long as there are crosswalks; however, in this case, NASA did not have alternative codes for Recoveries and therefore did not have related crosswalks to the SGL accounts.
14. As stated in our report, NASA's fiscal year 2000 financial statement audit was not complete when we completed our fieldwork, and therefore we did not review the fiscal year 2000 NASA financial statements or Arthur Andersen's working papers supporting its fiscal year 2000 audit to determine whether the fiscal year 1999 SBR errors were appropriately reported or whether Arthur Andersen's audit work was adequate.
15. Our report accurately reflects the nature and significance of the SBR errors and why Arthur Andersen's work was not sufficient to support its unqualified opinions on the SBR and Statement of Financing or its conclusion that NASA's systems substantially complied with FFMIA.

16. We found that the NASA IG had a reasonable checklist that it used to oversee the Arthur Andersen audit and are pleased that the NASA IG believes it was able to improve Arthur Andersen's audit quality in the areas mentioned. However, the NASA IG did not identify the \$1.3 billion of errors in the SBR or question the limited extent of the audit procedures applied to the budgetary statements or to assess compliance with FFMIA. As stated previously, the NASA IG has agreed to implement our recommendation to review the procedures it uses to oversee the work of its independent public accountants.
17. Although we agree with the NASA IG that GAGAS do not require an audit opinion on internal controls or compliance with laws and regulations, Arthur Andersen's work was not sufficient to meet GAGAS requirements relating to the auditor obtaining a sufficient understanding of the internal control structure and assessing control risk.
18. We disagree with the NASA IG's characterization of Arthur Andersen's procedures relating to Recoveries as being valid analytical review procedures. As discussed in our report, Arthur Andersen's analytical procedures were inadequate and did not meet the requirements of SAS No. 56. Specifically, the standard requires that significant differences be investigated and any explanation of the differences by management be corroborated. SAS No. 56 calls for procedures that involve comparisons of recorded amounts or ratios developed from recorded amounts to expectations developed by the auditor. Assuming that the fiscal year 1998 amount for Recoveries was correctly reported as \$0, the auditor expectation would likely have been that the fiscal year 1999 amount was \$0. However, the reported amount was \$686 million. This test did not meet the requirements of SAS No. 56 because no expectation was documented or used in the procedure, and Arthur Andersen did not independently corroborate a questionable explanation by NASA of the substantial change in the balance. It is important to note that, according to NASA, the fiscal year 1998 Recoveries line item was understated by \$80 million.

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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

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